I. INTRODUCTION

In these proceedings Fitchburg Gas and Electric Light Company ("FG&E" or "the Company") seeks new base rates for its Electric and Gas Divisions in order to allow FG&E the opportunity to recover the cost to serve its customers and earn a reasonable rate of return on its investments in its local utility systems. This filing is the first base rate increase FG&E has requested for its Electric Division since 1984, and the second base rate increase FG&E has sought for its Gas Division in 18 years. The Company found it necessary to seek a rate adjustment in 2002 in order to support increasing investments in its utility systems, including major capital improvements to enhance the systems reliability and to meet federal and state safety requirements. The updated base rates are also needed to allow FG&E the opportunity to recover costs it is incurring to fully accommodate the unbundling of its utility services and the implementation of competitive choices for customers. The new rates for the Company's Electric and Gas Divisions will establish cast-off rates for FG&E's ten year Performance Based Regulation ("PBR") plans filed in conjunction with this proceeding.

For the Gas Division, the requested rate adjustment is needed to support the 50% increase in FG&E's net investment in its gas distribution system since the test year for its last rate case in D.T.E. 98-51 (1998). This significant growth in the Company's investments for its Gas Division is needed to fund mandatory gas main replacements and other non-revenue producing safety and reliability improvements. The new gas rates also reflect increases in the Company's operating costs including employee wages and benefits, insurance, property taxes and other business expenses during a period when overall customer and revenue growth has been flat or declining.

For the Electric Division, the rate adjustment is needed to support the depreciation adjustment that was deferred in the Department's last review of FG&E's rates in D.T.E. 99-118 (2001). The new rates also reflect the Company's increased capital investments and certain restructuring costs which the Department determined should be recovered in base rates. See Fitchburg Gas and Electric Light Company, D.T.E. 99-110 (Phase II) at 24-25 (2001). Additionally, the proposed adjustments to FG&E's electric rates are needed to support the rising costs of employee benefits, insurance, property taxes and other normal business expenses.

Since 1985, FG&E has maintained a successful record of managing its business to avoid base rate increases. However, the combination in recent years of rising operating costs, the need for major capital additions and declining growth in sales and revenues, in both the Gas and Electric Divisions, requires FG&E to seek a rate adjustment at this time. The proposed rate adjustments are also intended to establish cast-off rates for the Gas and Electric Division PBR plans filed with the Department on April 16, 2002.

FG&E has supported its request for a base rate increase with a comprehensive and efficient substantive case presented by internal and external expert witnesses. During the course of expedited discovery in this proceeding, FG&E responded to approximately 1,000 information and record requests. The Company presented five witnesses during 16 days of evidentiary hearings. No witnesses were offered by any of the intervening parties and many components of the Company's presentation were uncontested at the hearings or in the intervenor's initial briefs. FG&E has presented a balanced and well-documented rate filing which is consistent with Department precedent, responsive to Department directives and which does not reflect extreme litigation positions.

This initial brief for FG&E summarizes its prima facie case, for both the Gas and Electric Divisions, explains how that case is consistent with applicable Department precedent and legal standards, and responds to the issues raised by the intervenors. The Company's requests for new rates, as presented in its testimony and exhibits and summarized in this brief, are just and reasonable, and fully supported by a comprehensive evidentiary record.

II. PROCEDURAL HISTORY

Pursuant to M.G.L. c. 164, § 94, and 220 C.M.R. 5.00, FG&E filed revised rates and charges for electric service (rate schedules M.D.T.E. 86-89, and Cancellation Supplement M.D.T.E. No. 80), and for gas service (rate schedules M.D.T.E. 110-117) with the Department of Telecommunications and Energy (the "Department") on May 17, 2002. FG&E specified an effective date for the electric and gas rate schedules of June 1, 2002. The electric and gas rate schedules were designed to produce increased total annual revenues from the currently effective base rates in the amount of approximately $3,206,768 for the Electric Division, and $3,413,357 for the Gas Division, based upon a test year that ended December 31, 2001. These amounts represent an overall increase of approximately 4.7% in the total electric revenues and 15% in total gas revenues. FG&E also filed a proposed PBR plan for both its Gas and Electric Divisions.

The proceedings to investigate FG&E's rate proposals were docketed as D.T.E. 02-24 (Gas) and D.T.E. 02-25 (Electric).[1] Simultaneously with the initial filing, FG&E filed with the Department a Motion to Consolidate for Hearings the gas and electric rate proceedings, which the Department granted at the June 21, 2002 procedural conference.

FG&E submitted prefiled prepared written testimony of five witnesses, together with related supporting schedules, studies and work papers. FG&E's witnesses in these proceedings are: (1) Mark H. Collin, Treasurer and Secretary of Unitil Corporation and Vice President of Finance of Unitil Service Corp.; (2) Karen M. Asbury, Director of Regulatory Services of Unitil

[1] The Department docketed the PBR Plans as D.T.E. 02-22 (Gas) and 02-23 (Electric) but did not consolidate them with the rate cases. To date, the Department has taken no further action on the proposed PBR Plans.

Service Corp.; (3) James L. Harrison, Principal with the consulting firm of Management Applications Consulting, Inc.; (4) Dr. Samuel C. Hadaway, Principal in Financo, Inc.; and (5) James H. Aikman, Managing Consultant with Management Applications Consulting, Inc. See Exhs. FGE-MHC-1, FGE-KMA-1, FGE-JLH-1, FGE-SCH-1, and FGE-JHA-1.

By Order of the Department dated May 28, 2002, the effective date of the filed electric and gas rates was suspended and the use thereof deferred until December 3, 2002. Hearings for public comments were scheduled and held in Fitchburg, Massachusetts, on June 20, 2002.

The Attorney General of the Commonwealth of Massachusetts (the "Attorney General") filed a Notice of Intervention on June 10, 2002. The Massachusetts Division of Energy Resources (the "DOER") also filed a Petition to Intervene on May 29, 2003. By a filing dated June 11, 2002, Boston Edison Co., Cambridge Electric Light Co., Commonwealth Electric Co. and NSTAR Gas Company sought limited participant status. Also, by a filing dated June 13, 2002, Boston Gas Company, Colonial Gas Company and Essex Gas Company, sought limited participant status. All intervention petitions were granted by the Hearing Officer at the June 21, 2002 prehearing conference without objection by FG&E. At the prehearing conference, the Department established the discovery schedule, set ground rules for the case, and established dates for evidentiary hearings and the briefing schedule. On June 26, 2002, the Attorney General appealed the procedural schedule. None of the intervenors filed testimony or sponsored an expert witness to respond to the Company's request for a rate increase.

The Department held 16 days of evidentiary hearing between August 5, 2002 and September 10, 2002 at its offices in Boston, Massachusetts. During the course of discovery and hearings, the Company responded to approximately 1,000 information and record requests. On

September 25, 2002, the Attorney General and the DOER submitted initial briefs.[2] FG&E now submits its initial brief and the Attorney General and the DOER are expected to file their reply briefs to FG&E's brief on October 17, 2002. FG&E will then file a reply brief on October 24, 2002.

III. BACKGROUND

A. FG&E and the Unitil System of Companies

FG&E is a Massachusetts corporation and gas company, incorporated under chapter 208 of the Acts of 1852 as Fitchburg Gas Company, for the purpose of manufacturing and selling gas. Exh. FGE-MHC-1 (Gas) at 009. In 1889, Fitchburg Gas Company was authorized by the Board of Gas and Electric Light Commissioners (the predecessor to the Department) to engage in the business of generating and selling electricity. FG&E remains today a single, integrated corporate entity with two divisions: the Electric Division and the Gas Division. See e.g. Attorney General v. Dep't of Pub. Utils., 392 Mass. 262, 467 N.E.2d 72, 76 (1984). Under the provisions of M.G.L. c. 164, FG&E is defined as a gas utility with electric distribution operations. See, M.G.L. c. 164, as amended, §1(a). FG&E serves approximately 27,000 electric customers and 15,000 gas customers in Fitchburg and its neighboring communities.

Pursuant to a settlement between the Attorney General and FG&E in 1992, the Department approved the merger of FG&E with Unitil Corporation. See D.P.U. 84-66 (1992). Unitil Corporation is a registered public utility holding company and a New Hampshire corporation. Exh. FGE-MHC-1 (Gas) at 009. Other Unitil System companies include two New Hampshire electric distribution utilities, Concord Electric Company ("CECo") and Exeter & Hampton Electric Company ("E&H"); Unitil Power Corp., a public utility under the Federal

[2] The Attorney General did not meet the filing deadline for submittal of his initial brief. No party has moved to reject the Attorney General's pleadings as untimely, but the Hearing Officer has provided notice that failure to meet such deadlines in the future may result in the rejection of the Attorney General's pleadings.

Power Act which provides wholesale electric power to CECo and E&H ("Unitil Power"); Unitil Service Corp. ("USC"), which provides management and administrative support services to all of the Unitil companies, including FG&E; Unitil Resources, Inc., an electric and gas brokering company ("Unitil Resources"); and Unitil Realty Corp., which owns and leases certain real property (primarily the Unitil Corporation headquarters) for the use of the utility and non-utility affiliates ("Unitil Realty") (together, the "Unitil System"). Id. at 010.

B. Shared Services and Allocation of Common Costs

1. Until Service Corp.

The Unitil Corporation is a registered public utility holding company under the Public Utility Holding Company Act of 1935 ("'35 Act") and is regulated by the Securities Exchange Commission ("SEC"). Unitil Corporation owns all the common stock of the retail affiliates and of the non-utility affiliates. The Department has recognized that the '35 Act imposes "significant regulatory requirements." Blackstone Gas Co., D.P.U. 94-177 at 5-6 (1995).

Under the '35 Act, it is

> unlawful for any subsidiary company of any registered holding company . . . to enter into or take any step in the performance of any service . . for . . . any associate company thereof except in accordance with such terms and conditions and subject to such limitations and prohibitions as the [SEC] by rules and regulations or order shall prescribe as necessary or appropriate in the public interest or for the protection of investors or consumers and to insure such contracts are performed economically and efficiently for the benefit of such associate companies at cost, fairly and equitably allocated among such companies.

'35 Act at §13(b); 15 U.S.C. §79m(b). Consistent with Section 13(b), the SEC has promulgated rules 90(a), which prohibits affiliates from selling services to each other at "more than cost," and

91(a), which defines "more than cost" as "not exceeding a fair and equitable allocation of expenses." See 17 C.F.R. §250.90(a); 17 C.F.R. §250.91(a).

Unitil's three distribution utilities rely on centralized and integrated services provided by USC.[3] Exh. FGE-MHC-1 (Gas) at 010. Until has structured its utility business operations in this way in order to achieve system-wide efficiencies through economies of scale, elimination of duplicate functions and best business practices. Id. When Unitil was formed, it also created USC as a centralized, shared services company. Id. Today, USC provides a variety of shared utility services to CECo, E&H and FG&E, at cost, in six major functional areas: 1) Corporate and Administration; 2) Customer Services; 3) Energy Services; 4) Engineering and Operations; 5) Regulatory, Finance and Accounting; and 6) Technology. Id.

In preparing this case, and in response to the Department's directives in D.T.E. 98-51, FG&E conducted an internal audit of the USC test year charges. Exh. FGE-MHC-5 (Electric); see Fitchburg Gas and Electric Light Co., D.T.E. 98-51 at 31 (1998). The purpose of the internal audit was to provide a basis for the Department's review and investigation of the nature of the USC charges to FG&E. Exh. FGE-MHC-1 at 014-015. The internal audit indicated that FG&E received 39.97% of the total service company services in 2001, and that the service company charges invoiced to FG&E by USC in 2001 were reasonable and appropriate. Exh. FGE-MHC-5 at 268.

2. FG&E's Allocations of Common Cost

FG&E incurs certain common costs for its Gas and Electric Divisions which are allocated to each division based on certain allocation factors. Exh. FGE-MHC-1 (Electric) at 053. In

[3] Earlier this year, Unitil filed a restructuring proposal for its New Hampshire affiliates under which CECo and E&H would be merged into one distribution utility. Exh. AG-7-01. Unitil has also filed for new rates for its New Hampshire distribution operations based upon a 2001 test year. Thus, new rates for Unitil's Massachusetts and New Hampshire distribution utilities will be established based upon the same test year, including the allocated cost of shared services from USC.

preparing this rate filing, FG&E commissioned a new Common Cost Allocation study to ensure the validity of its allocation methodology since the last study conducted in 1978. Id.; citing FG&E Gas and Electric Common Cost Allocation Study (3/28/02), Exh. FGE-MHC-6 (Electric). That Study recommended that FG&E utilize a new allocation methodology reflecting DTE precedent for each account containing common costs. Exh. FGE-MHC-6 (Electric) at 323-324. Based upon the Department's decision in FG&E's last fully litigated rate case, the Study recommended the use of five different methods to allocate costs in accounts containing common costs:

a. Plant Related Items
b. Labor Related Items
c. Customer Related Items
d. Number of Bills Related Items
e. Net Revenue Related Items

The results of this process showed allocations for the test year of 35.75% for gas and 64.25% for electric. Id. at 321. These results are nearly identical to those for the test year results under FG&E's prior allocation methodology. Id.

C. Rate Case History

1. Electric Division

FG&E last requested a base rate increase for its Electric Division in 1984. Exh. FGE-MHC-1 (Electric) at 010; Fitchburg Gas and Electric Light Co., D.P.U. 84-145 (1985). During the 18 years since its last base rate request, FG&E was the only electric utility in the Commonwealth not to seek one or more base rate increases. In 1993, FG&E requested, and the Department granted, a voluntary base rate decrease to flow back to its customers the savings resulting from a debt financing. D.P.U. 93-165 (1993).

The Department reviewed FG&E's Electric Division rates in D.T.E. 99-118 in response to a Section 93 request by the Attorney General. The revenue requirement for the Electric Division in this case, based on a 2001 test year, shows a significant decrease in FG&E's electric base revenues since the Department's review in D.T.E. 99-118, which was based on 1999 test year. Exh. FGE-MHC-1 at 011. That reduction reflects a number of factors besides the 8.3% decrease in base rates required by the Department in D.T.E. 99-118. FG&E's current revenue deficiency is the result of both increased operating costs and a significant drop in electric sales of 8.8% since 1999. Exh. FGE-MHC-1 (Electric) at 011. Since that time, FG&E has made significant capital investments in its electric distribution system, including $5,240,735 in the Sawyer Passway distribution substation during 2000 and 2001. DTE-RR-2. Additionally, in D.T.E. 99-118 the Department deferred consideration of FG&E's electric depreciation accrual rates, which FG&E is now seeking to increase based on an updated depreciation study. See D.T.E. 99-118 at 51.

The need for FG&E to seek a base rate adjustment in this proceeding was also impacted by the Department's restructuring initiatives. In D.T.E. 99-110, FG&E sought to recover certain costs incurred by FG&E in the unbundling of its electric service to provide customer choice, including costs associated with providing supplier access to its distribution system, standard offer service and default service. Exh. FGE-MHC-1 at 011. With the support of the Attorney General, the Department rejected recovery of these costs in FG&E's reconciling restructuring charges and directed FG&E to seek recovery of these costs in base distribution rates. See D.T.E. 99-110 at 25.

2. Gas Division

This filing represents just the second request for base rate increase by FG&E's Gas Division in 18 years. Exh. FGE-MHC-1 (Gas) at 011. FG&E sought a base rate adjustment for the Gas Division four years ago in DTE 98-51. Prior to that, FG&E had not requested an increase in its base rates since 1984 in DPU 84-145. Id.

In FG&E's last base rate case for its Gas Division, FG&E filed for an increase of $1,552,606, or 9.63% of distribution revenues, and was granted an increase of $998,210, or 6.03%. Exh. FGE-MHC-1 (Gas) at 011. Id. Since the test year for its last rate case, FG&E's net investment in its gas system increased by 50%, from approximately $20 million to $30 million. Id. at 012. This significant growth in FG&E's rate base investment is driven primarily by mandatory gas main replacements, upgrades, and other non-revenue producing improvements to ensure the safety and reliability of the gas distribution system. Id. During a period of declining load growth and large customer attrition, the Company has also experienced increasing costs for wages and benefits, insurance, property taxes and bad debt expenses. The increase in FG&E's costs also reflects new investments and expenses required to support the gas restructuring process, including customer-information systems, supplier interfaces and increased regulatory activities. Id.

IV. SUMMARY OF REVENUE REQUIREMENTS

A. Method of Analysis

In developing the revenue requirements for both the Electric and Gas Divisions, FG&E determined the cost-to-serve based on the calendar 2001 test year, pro formed and adjusted for known and measurable changes. Exh. FGE-MHC-1 (Gas and Electric) at 013. By comparing each division's cost-to-serve to its adjusted test year revenues, FG&E determined a revenue deficiency and the revenue requirement needed to make up that deficiency. Id. This methodology reflects the Department's precedent allowing a utility an opportunity to recover the reasonable cost to serve its customers and earn a fair return on its investment. Re Boston Edison Co., D.P.U. 906 (1982); see also Duquesne Light Co. v. Barasch, 488 U.S. 299, 307 (1989).

In calculating its rate base, operating revenue and operating expenses, FG&E used historical test year data for the twelve month period ending December 31, 2001. This data was then pro formed for known and measurable changes to each division's revenue requirement to determine normalized revenues and expenses for establishing rates. Exh. FGE-MHC-1 (Gas and Electric) at 013. Pro forma adjustments to the test year were based either upon known and measurable charges in revenues and expenses, or upon charges that will become known and measurable during the proceeding. Id. Based upon Department precedent, some expense adjustments reflect known and measurable changes that will be experienced in the rate year, which is the first twelve months in which the new rates are in effect (December 1, 2002 through November 30, 2003). See Massachusetts-American Water Co., D.P.U. 88-172 at 7-9 (1989); Bay State Gas Co., D.P.U. 1122 at 70-72 (1981).

B. Prior Directives

In preparing its filings for both the Electric and Gas Divisions, FG&E has complied with a number of directives of the Department from prior proceedings. Exh. FGE-MHC-1 (Electric) at 014-015; Exh. FGE-MHC-1 (Gas) at 015. Based upon the Department's Order in DTE 99-118, FG&E's electric filing addresses: 1) the prudence of FG&E's investment in the transformer originally installed to serve Princeton Paper Company; and 2) the appropriateness of a lead lag study or use of the 45 day convention for non-fuel working capital requirements. See D.T.E. 99-118 at 25 and 30. In response to the Department's Order in D.T.E. 98-51, FG&E's gas filing also addresses cash working capital allowances, test year service company charges allocated to FG&E, SEC audit expenses, rate case expenses and the water heater rental program. Id. at 015 (Gas); See D.T.E.98-51 at 16, 31, 42, 60, and 67.

C. Summary of Results

1. Electric Division

As shown in FG&E's initial filing, based upon the 2001 test year cost of service, as compared to adjusted operating revenues, FG&E's Electric Division experienced a distribution revenue deficiency of $3,206,768 on an overall rate of return of 9.09%, and known and measurable adjustments to test year revenues, expenses and rate base. Exh. FGE MHC-1 (Electric) at 015-16, Sch. MHC-2. The Electric Division experienced a total revenue deficiency in the test year of $3,655,806, which reflects the inclusion of a revenue deficiency of $449,038 for the FERC-jurisdictional Internal Transmission function. Id. Based upon the updates provided during the course of this proceeding, FG&E's total revenue deficiency for the Electric Division is $3,982,358, including a deficiency of $3,505,849 for the distribution function and $476,508 for the internal transmission function. DTE-RR-6, updated 10/02/02 at Sch. MHC-2 (Electric).[4]

Because of the rate cap imposed by the Electric Restructuring Act of 1997, the proposed increase in FG&E's annual distribution revenues will have a limited effect on customer bills. FG&E proposes to reduce the Transition Charge to accommodate the distribution revenue changes beneath the rate cap. Exh. FGE-MHC-1 (Electric) at 017.

2. Gas Division

Based upon the 2001 test year cost of service, as compared to adjusted operating revenues, FG&E's Gas Division experienced a distribution revenue deficiency of $3,372,331, based on an overall rate of return of 9.09% and known and measurable adjustments to test year revenues, expenses and rate base. Exh. FGE-MHC-1 (Gas) at 016. The Gas Division experienced a total revenue deficiency of $3,413,357, which reflects the inclusion of a revenue deficiency of $41,026 for the production function. Id. Based upon the updates provided during the course of this proceeding, FG&E's total revenue deficiency for the Gas Division is

[4] The final "functional allocation" of the total revenue deficiency between the distribution function and the internal transmission function for both the Electric and Gas Division’s rates will be performed at the time of FG&E's compliance filing in this proceeding in accordance with the Company's allocated cost of service study methodology and directives of the Department. During the course of the proceeding the Companies' updates to the revenue deficiency have been allocated to each function proportionately based on the revenue deficiency determined for each function as originally filed relative to the total revenue deficiency for the Electric Division.

$3,430,923, including a deficiency of $3,396,789 for the distribution function and $34,134 for the production function. See fn. 5.

V. REVENUE REQUIREMENT

A. Rate Base

FG&E used actual per books amounts as at the end of the test year for Utility Plant in Service, Reserve for Depreciation and Amortization, Reserve for Deferred Income Taxes and Customer Deposits. Exh. FGE-MHC-1 at 018, Sch. MHC-4 (Electric); Exh. FGE- MHC – 1 at 018, Sch. MHC-4 (Gas). All included plant is used and useful in the service of customers. Id. The level of inventories included in rate base is based on the average of the 13 month-end balances of the test year. Id. Only limited pro forma adjustments were made to the test year rate base. Id.

1. Utility Plant in Service, Plant Additions and Capital Improvements

a. Electric Division

Since 1999, FG&E's Total Electric Utility Plant in Service has grown to $68,406,718. DTE-RR-6, updated 10/02/02, at Sch. MHC-4 (Electric) and Sch. MHC-8 (Electric). The growth in Total Electric Utility Plant in Service results from not only routine replacements and upgrades, but a series of system integrity and reliability evaluative projects to determine areas of capacity constraint and to predict problem areas in the electrical system to ward off outages resulting from equipment failures. Exh. FGE- MHC-1 at 018-19 (Electric); Exh. AG-1-19. These concentrated review efforts determined that many upgrades and replacements were necessary in order to maintain and protect the integrity and reliability of the system. Id., see also Exh. FGE-MHC-3 (Electric).

Utility Plant in Service was presented as a component of rate base, with balances of plant accounts as at December 31, 2001. Exh. FGE-MHC-1 at Sch. MHC - 8 (Electric). Total Electric

Utility Plant was reduced by the asset balances related to other power generation, stranded assets/jointly-owned units and the Electric Water Heater Rental Program ("Rental Program"), and increased by the portion of Common Plant allocated to the Electric Division.

In D.T.E. 99-118, the Department indicated that it would review in the future whether FG&E was prudent in adding a transformer at Princeton Road to serve a customer, Princeton Paper Company ("Princeton Paper"), that declared bankruptcy and ceased taking service in 2000, and whether that transformer is now used and useful.[5] See D.T.E. 99-118 at 25.

i. Prudence of Princeton Paper Upgrades

Princeton Road Substation was not constructed solely to serve Princeton Paper.[6] It was originally built in 1996 to serve FOLLC/Massachusetts Recycling Associates, L.P. ("MRALP")/Princeton Paper and other FG&E customers on two other circuits. Exh. FGE-MHC-1 (Electric) at 020; Exh. AG-7-54. As constructed in 1996, the portion of the substation dedicated to FOLLC/MRALP/Princeton Paper was intended to serve a load of 11.5 MVA firm and 17 MVA on an interruptible basis. See Exh. AG-7-55.

In 1998, the substation at Princeton Road was expanded to accommodate an additional transformer with a rating of 12/16/20 MVA. See Exh. MHC-1 at 022 (Electric); Exh. AG-7-54. The customer provided an advance under an Energy Bank Service Agreement ("Service Agreement") for the purpose of constructing the facilities necessary to serve this new load. Exh.

---

5 Under the Department's standard of prudence, a regulated company's actions must be prudent at the time they are undertaken, taking into account all the factors that were known or should have reasonably been known to the company at that time. Western Massachusetts Elec. Co., D.P.U. 92-8C-A at 6 (1993).

6 Princeton Paper was a paper recycling company formerly known as Fitchburg Operating, L.L.C. ("FOLLC"). Exh. FGE-MHC-1 (Electric) at 020. At the time the customer approached FG&E, it was one of the largest construction projects in the Commonwealth. D.T.E. 99-118 at Tr. 6/1/01 (Vol 2) at 247. Because of the unique characteristics of the customer and its size, FG&E entered into a special contract to serve the Princeton Paper load. Id. At its peak, in 1999, Princeton Paper contributed 29 percent of the base distribution operating revenues from the GD-3 class, or in other words, over 8 percent of the total base Electric Division distribution operating revenues. Exh. FGE-MHC-1 (Electric) at 020. In 2000, Princeton Paper contributed 13 percent of the GD-3 class base distribution operating revenue, or approximately 3 percent of FG&E's total base distribution operating revenues. Id. In spite of FG&E's efforts to work with and assist the customer, by 2001 Princeton Paper had sold all its assets at auction and a new tenant occupied the facilities. Id.; Exh. AG-RR-1 (c).

AG-1 at 9 (Sch. 1). It should be noted that the current load at this facility, as it exists today ("Newark"), is approaching 10 MVA. See id.; Exh. AG-7-54. By 1999, however, Princeton Paper was experiencing financial difficulties that ultimately led to bankruptcy and liquidation. See Exh. FGE-MHC-1 at 020 (Electric); AG-RR-1(c).

During this same time period, FG&E's engineers were seeking cost-effective ways of further increasing capacity in the Princeton Road area because industrial load had been growing. Exh. MHC-1 at 021 (Electric). Preliminary designs called for another substation in the Princeton Road vicinity to serve this load. Id. When it became clear that Princeton Paper would cease operations in 2000, FG&E's engineers were able to reconfigure the system and move load from constrained areas on the FG&E System to the Princeton Road substation. Id. This reconfiguration avoided the need for another substation. Exh. FGE-MHC-1 at 21 (Electric); Exh. DTE-2-25.

The Princeton Road substation now feeds the demand created by other industrial customers along Princeton Road, including the Montachusett Industrial Park, the 231 Industrial Park, and many other industrial, commercial and residential customers. Id. Therefore, the Princeton Road Substation is used and useful in the service of ratepayers.

FG&E also used the transformer no longer required at Princeton Road to replace the transformer that failed at West Townsend Substation, saving the cost of a new unit. Exh. FGE-MHC-1 (Electric) at 022; Exh. DTE-2-23; Exh. DTE-2-30. Finally, the Princeton Road substation enhances reliability of the system as it acts as a back up to the River Street Substation, where there was a failure in the past year, and it feeds customers on River Street. Exh. FGE-MHC-1 (Electric) at 022; Exh. DTE-2-24.

Any excess transformer capacity temporarily on the system at the closing of Princeton Paper and the opening of Newark America has now been absorbed, with more distribution load on that substation than on any other distribution substation in the FG&E system. See Exh. FGE-MHC-1 (Electric) at 022; Exh. DTE-2-26 (summer 2002, 25% of system load). The load on the Princeton Road Substation is currently in excess of 20 MVA (summer 2002, 24.2 MVA) because of the rerouting of circuits. See Exh. FGE-MHC-1 (Electric) at 022. This load accounts for more than 20 percent of all of FG&E's load. Id.

The Princeton Road substation is used and useful in the service of ratepayers. Exh. DTE-2-29. FG&E's actions with regard to the Princeton Road, both in deciding to construct it and then reconfiguring the system following the closing of Princeton Paper, were prudent, and the facility is appropriately included in FG&E's Electric Division Rate Base as used and useful.

ii. The Attorney General Misapprehends the Benefits to Ratepayers of the Princeton Paper Deposit Bankruptcy Court Reclassification

The Attorney General claims that FG&E received "equipment deposits related to the Energy Bank contract for electric service" that he claims should be credited to the Electric Division's rate base, because "other customers" are paying for the investment made to serve Princeton Paper, now bankrupt. AG Br. at 6-7. The Attorney General's proposal is without merit, as is his assertion that FG&E failed "to disclose the claim" filed in bankruptcy court or the bankruptcy court approval of the Princeton Paper settlement in an earlier proceeding.[7] AG Br. at 6.

---

[7] The questioning in the hearing focused entirely on the post petition bankruptcy status of the Energy Bank Contract. TR-6/1/02. The Attorney General did not seek information about the settlement of pre-petition claims. In D.T.E. 99-118, Mr. Collin was asked: "Did Princeton Paper file bankruptcy?" (p. 296, line 19); "Do you know when they filed bankruptcy?" (p. 296, line 21); "Did the bankruptcy judge take jurisdiction of the contract Princeton Paper had with [FG&E]?" (p. 296-7, lines 23-24, 1-2); "Did FG&E receive some type of order from the bankruptcy judge or the trustee regarding the obligations of Princeton Paper under that contract?" (p. 297, lines 3-6); "[M]y question is more specific. Did the Bankruptcy Court change any of the provisions of the contract -- specifically the demand

First, the Princeton Road Substation is used and useful for existing customers and should be paid for by them. Second, the monies put up by Princeton Paper were a "construction deposit" under the Energy Bank Service Agreement to ensure that Princeton Paper in fact came on line as a customer of FG&E; once it did, the monies were to be returned. Exh. AG-2 (Service Agreement at 1¶ 5. 2. 1). Therefore, as Mr. Collin testified, the only way -- with the bankruptcy -- that FG&E would be able to offset the construction deposit against pre-petition amounts owed, would be if it was determined by the Bankruptcy Court that it was such a security deposit and could be set-off under Section 553 of the Bankruptcy Code. Tr. 8/23/ 02 (Vol. 11) at 1310-1311; Exh. AG-1 (Service Agreement at ¶ 5.3). Under the Code's provisions, if a creditor and a debtor have mutual, valid pre-petition claims, the creditor can set off his pre-petition debt against the assets claimed by the bankruptcy estate. 5 COLLIER ON BANKRUPTCY (Matthew Bender) ¶553.510 (15th ed.)

The Bankruptcy Court approved the Settlement and the set-off and FG&E was able to recover almost half of its pre-petition debt and associated costs. Tr. 8/23/02 (Vol. 11) at 1310-1311; Tr. 9/10/02 (Vol. 15) at 1877-1878; see, Exh. AG-2 (Motion for Settlement). Therefore, at the time FG&E recovered these dollars, they were decidedly not construction-related, but a set-off in bankruptcy of a security deposit against outstanding amounts owed for electric and gas service. To rule otherwise would be to contravene the ruling of the Bankruptcy Court. The Company's actions avoided a write off of these balances, which would have negatively impacted bad debt expense and unnecessarily increased costs to other electric and gas customers.

---

charge? Did they reduce your demand charge, eliminate it?"(p. 297, lines 20-24); "[I]t's your testimony here today that the payments under the demand charge continued unabated?" (p. 298, lines 2-4).

iii. Sawyer Passway Substation

Sawyer Passway ("Electric Station") was originally the site of a manufactured gas plant dating back to the turn of the century; later converted to a generating facility serving the downtown Fitchburg area. Expansions and upgrades of generation and ancillary electric facilities occurred at various times over the life of the facility, though major portions of the electric equipment date from the late 1940's and early 1950's. These facilities were designed primarily to deliver generation to Fitchburg customers, and later to interconnect generation to the transmission system, not to serve as a distribution substation. The substation at Sawyer Passway was designed originally to interconnect generation to the system. Exh. FGE-MHC-1 (Electric) at 023. Over time, because it was close to the downtown and because of its location relative to the downtown area of Fitchburg, the substation evolved into a major distribution load center. Id. However, the system connections and configurations were not ideally suited to distribution service, as they were configured in a manner that limited protections for overcurrent and lightning strikes. Id.; Exh. DTE-2-25. Additionally, because of the age of the facility, voltage could only be adjusted manually, with limited capability. Exh. FGE-MHC-1 (Electric) at 023.

The substation was scheduled for retirement and replacement because its distribution operations limitations were obvious, and in addition, because of the prior use as a generating station, the building contained asbestos materials, making it dangerous for personnel to work in the facility.[8] Exh. FGE-MHC-1 (Electric) at 023; Exh. DTE-2-25. Retirement and replacement of the facility became even more critical when a serious fire occurred on the site. Exh. FGE-MHC-1 (Electric) at 023; AG-RR-51. Because this equipment services downtown Fitchburg, however, it was necessary to ensure that a replacement substation would be phased-in to

[8] Asbestos was widely and routinely used by utilities in generating stations for fire protection before its hazards to human health were scientifically established. Exh. FGE-MHC-1 (Electric) at 023.

maintain reliable voltage levels, be properly grounded, protect against overcurrent and lightning strikes, and provide for better voltage adjustment. Exh. FGE-MHC-1 (Electric) at 023.

Since the test year, the new Sawyer Passway substation has been in service with two 12/16/20 MVA LTC transformers Exh. FGE-MHC-1 at 024. The new Sawyer Passway substation is used and useful in the service of ratepayers and is appropriately included in the Electric Division's rate base.

iv. The Attorney General Misconstrues Regulatory Precedent in His Assertions that the Status of the Former Sawyer Passway Substation Makes it Not Used and Useful

The Attorney General incorrectly claims the former Sawyer Passway substation is no longer "used and useful" and should be removed from FG&E's rate base. AG Br. at 7. The Attorney General bases his factual premise on the evidence that the new Sawyer Passway substation went on line in early 2000, and the old substation was taken off line in January 2002. AG Br. at 7-8, citing Tr. 12 at 1426; AG-RR-52. He bases his legal argument on the rate-making "used and useful" concept and the application of that ratemaking concept to abandoned plant. See AG Br. at 8, citing Fitchburg Gas and Elec. Light Co., D.P.U. 18296/18297 (1975); Fitchburg Gas and Elec. Light Co., D.P.U. 19084 (1978).

The former Sawyer Passway Substation was in-service in the test year and FG&E continues to incur significant costs in retiring this substation, which provided used and useful service to FG&E's customers for over 50 years.[9]. While the Department may review plant

---

[9] AG-RR-52 incorrectly identified the test year depreciation expense for the former Sawyer Substation as $61,516, which amount was incorrectly derived by taking the original cost of the substation found in Account 362 and multiplying it by the 5.95% depreciation rate for Account 364, Distribution Poles, Towers and Fixtures. The correct test year depreciation expense is $32,671 and is calculated by multiplying the original cost of the substation of $1,033,889 by the 3.16% depreciation rate for Account 362, Station Equipment (which is one line above account 364), per Exh. FGE-JHA-1 (Electric)at 38. To clarify the record, Mr. Collin's schedules include the following figures for the former Sawyer Passway substation, which the new Sawyer Passway substation is designed to replace: Plant in Service, $1,033,889; Depreciation Reserve, $639,216 and annual depreciation expense of $32,671.

previously included in rate base and determine whether or not it remains used and useful, the Department does not normally conduct such an analysis. It will only conduct such an inquiry if extraordinary circumstances exist. See Berkshire Gas Co., D.P.U. 92-210-B at 14 (1993). Furthermore, the Department requires that post-test year adjustments to rate base be unusual in nature and extraordinary in amount. Kings Grant Water Co., D.P.U. 87-288 at 17 (1988); Boston Edison Co., D.P.U. 1300 at 18 (1983); Nantucket Elec. Co, D.P.U. 91-106/91-138 (1991). In this instance, the retirement of a substation that is over 50 years old and its replacement by a new substation located at the same site is neither unusual in nature nor extraordinary in amount. Furthermore, post-test year adjustments to rate base are simply never based on the same "known and measurable" standard used for expense adjustments.

v. The Proposed Post-Test Year Adjustment is Neither Unusual in Nature or Extraordinary in Amount

In order to upgrade the Sawyer Passway Substation, FG&E had to keep the former Sawyer Passway substation active, thereby necessitating a redundant investment on this particular site. Sawyer Passway was squarely in service to ratepayers in the test year, supporting the new substation. AG-RR-52. Extraordinary circumstances do not exist for a post-test year change to rate base in this instance.

In other decisions, the Department has found that even where only 12 percent of an asset was used and the company clearly stated its intention to retire the asset, it was still used and useful in service to ratepayers and appropriate for inclusion in rate base. NYNEX, D.P.U. 94-50 at 298 (1995). The Department has taken into account where capital investments are necessary to accommodate future demand and has rejected attempts to penalize a regulated company for that outcome. Id. Moreover, FG&E's original investment in the former Sawyer Passway substation was prudent, and the substation is now off-line, but has not yet been fully retired .

AG-RR-52. FG&E's customers are equally responsible for removing the encasement, concrete, bricks and mortar, and until that costly process is completed, which is proceeding as expeditiously as possible, the plant is deemed by FG&E to be in service and is not retired.

Furthermore, the process of removing and retiring of the original Sawyer Passway Substation by 2003 constitutes a normal substation retirement.[10] This is not a case where a facility is abandoned because of pollution costs or some other extraordinary event that made the facility no longer cost-effective to run. Compare Fitchburg Gas and Elec. Light Co. v. Dep't of Pub. Utils., 371 Mass. 881, 886-887 (1977). Finally, the cost of the retirement is not extraordinary in amount, as the undepreciated cost in Rate Base is $394,673, included in an Electric Division rate base of $46,032,226, or just 9/10 of one percent. For these reasons, the Attorney General's proposal should be rejected.

vi. The Attorney General's Adjustment is Erroneous and Incomplete and Therefore Must be Rejected

Even if the Attorney General's adjustment to Plant-in-Service were appropriate, he errs in proposing to adjust plant in service without making a consistent set of adjustments for reserves, depreciation rates, and depreciation expense. See, Fitchburg Gas and Elec. Light Co. v. Dep't of Pub. Utils., 371 Mass. 881, 886-887 (1977); AG Br. at 9. To adjust plant-in-service as he has proposed would be incorrect regulatory accounting.

In fact, in addition to his recommendation that the substation be removed from plant-in-service, the Attorney General recommends the Department increase FG&E's depreciation reserves by the amount already included in reserves for the substation. AG Br. at 9. Reserves are a deduction to rate base. See, Western Massachusetts Electric Company, D.P.U 86-260-A

[10] It is appropriate for FG&E to have the opportunity to fully recover all the costs associated with this capital investment/asset, including the currently undepreciated amount of $394,673 and, importantly, the related cost of removal, currently estimated at over $600,000, until the asset is physically retired in 2003. The current year (2002) includes a Work Authorization in the amount of $600,000, to cover cost of removal.

(1987). Any proposal to increase reserves is a further reduction of a negative balance, or in other words, a double count. The appropriate adjustment should be a decrease to reserves. See, Fitchburg Gas and Elec. Light Co. v. Dep't of Pub. Utils., 371 Mass. 881, 886-887 (1977). Moreover, the magnitude of the Attorney General's proposed adjustment is in error. Any asset removed from service at the end of its useful life should be accounted for as a retirement in accordance with the Uniform System of Accounts for Electric Utilities (Plant Instruction 9. Additions and Retirements of Electric Plant), which reveals the following for this situation:

1. Utility Plant in Service is credited for original cost of the asset of $1,033,889 at December 31, 2001, with an offsetting debit entry of $1,033,889 to the Depreciation Reserve Account. In addition, any cost of removal associated with the retirement of the plant will also be charged to the Depreciation Reserve Account.

2. The appropriate retirement journal entry described above leaves the un-depreciated amount of $394,673, and the cost of removal in the Depreciation Reserve Account, indicating that, at 12/31/01, the entire cost of the facility has not been recovered from ratepayers at the time of retirement.

3. The net plant amount of the asset in Rate Base is unchanged by the retirement journal entry. Although the Plant in Service balance for this investment has been reduced to zero, the Depreciation Reserve Account balance used to develop rate base would include the undepreciated balance of $394,673 plus the net cost of removal.

4. The Attorney General’s proposal to increase the accumulated depreciation by $639,216, results in a double counting of the reserve balance associated with the facility, and differs from the proper adjustment by over $1.0 million, prior to any consideration for the net cost of removal, which will be finally determined upon retirement of the plant.[11]

Furthermore, proper ratemaking treatment for this type of post-test year adjustment to Plant-In-Service and the associated undepreciated balance should also address the computation of depreciation rates in order to be consistent with the methods advocated by FG&E’s

[11] Based on 2002 authorizations, project net cost of removal is budgeted to be approximately $600,000, reflecting significant removal and disposal costs related to the type and age of equipment that will be dismantled and removed from the site.

Depreciation consultant, Mr. James Aikman. The depreciation study should factor this undepreciated balance into development of new depreciation rates for the station equipment account (Account 362).

In summary, in order to address the Attorney General's proposal that the Department consider the former Sawyer Passway substation formally retired, the following proforma adjustments would need to take place to reflect appropriate regulatory accounting for ratemaking purposes:

1. increase to the level of rate base initially proposed by Mr. Collin equal to the increase in net salvage value and cost of removal, currently estimated to be approximately $600,000, and
2. increase depreciation expense consistent with the appropriate depreciation rate for Account 362, Distribution Station Equipment.

For all these reasons, the Attorney General's suggested adjustment to reduce plant in service and increase reserves is incomplete, incorrect and inconsistent with proper accounting treatment. Therefore, it should be rejected.

b. Gas Division

Since the 1997 test year in the Gas Division's last base rate proceeding, Utility Plant in Service has grown from $29,362,232 to $41,516,177. Exh. FGE-MHC–1 (Gas) at 018, Schs. MHC-8, MHC-9. Reducing this amount for the Reserve for Accumulated Depreciation and Amortization, Net Utility Plant for the Gas Division has grown by approximately 41% since 1997. Id.

Growth in Utility Plant is a result of significant investments to upgrade FG&E's gas system to maintain compliance with state and federal law to ensure safety and reliability. Id.; Exh. FGE-MHC-3; Exh. AG-1-19. Total Gas Utility Plant has been reduced by the asset balances related to the Water Heater and Conversion Burner Rental Programs ("Rental

Programs”), and increased by the portion of Common Plant allocated to the Gas Division. Exh. FGE-MHC–1 (Gas) at 019-20.

c. Removal of Capitalized Lease (Common)

FG&E proposes to remove the Building Lease for its operations center that was originally capitalized in rate base and instead properly place the annual rent expense in O&M expense for the purpose of setting rates. DTE-RR-41. The adjustment would reduce the Electric Division rate base by $1,046,941, and the Gas Division rate base by $903,032. Id.

In its initial filing, as it had done in D.T.E. 98-51, FG&E included its long-term lease for the FG&E Service Center, located on John Fitch Highway in Fitchburg, in its rate base, as a capitalized lease. See, Exh. FGE-MHC-1 at Sch. MHC-8 (Electric); Exh. FGE-MHC-1 at Sch. MHC-8 (Gas). During the hearing process, FG&E became aware that its capitalization of the lease was inappropriate under Department precedent even through this treatment was approved by the Department in D.T.E. 98-51. Tr. 8/22/02 (Vol. 10) at 1273-1277; DTE-RR-41; Nantucket Elec. Co., D.P.U. 88-161/168 at 123-125 (1988); see also New England Tel. & Tel. Co., D.P.U. 86-33-G (1986). Accordingly, FG&E seeks Department approval to remove the capitalized lease from rate base, and include the annualized rent expense in operating expenses, for determining the revenue requirement for the Electric Division and the Gas Division.

On his initial brief, the Attorney General makes an extensive argument regarding why the lease is inappropriate to be capitalized, to which FG&E would agree, given that FG&E had previously recommended eliminating the capitalized lease from rate base as appropriate. Compare AG Br. at 18 with DTE-RR-6, updated 10/02/02 at Sch. MHC-7-20 (Electric), Sch. MHC-7-22 (Gas). Inexplicably, however, the Attorney General fails to recommend the other appropriate regulatory treatment for this legitimate expense, that being inclusion in operating expense.

2. Reserves for Depreciation and Amortization

a. Electric Division Reserves

As of December 31, 2001, the balance in the Reserve for Depreciation and Amortization for FG&E's Electric Division was $19,886,504. DTE-RR-6, updated 10/02/02 at Sch. MHC-9 (Electric). Total depreciation and amortization reserves have been reduced by the Depreciation and Amortization Reserve balances related to other power generation, stranded assets/jointly-owned units and the Rental Program, and increased by the portion of reserves balances related to Common Plant allocated to the Electric Division. Id.

However, if the AG's adjustment to retire the former Sawyer Passway substation were accepted, an identical adjustment to reserves would be appropriate as discussed above.

b. Gas Division Reserves

As of December 31, 2001, the end of the test year, the balance in the Reserve for Depreciation and Amortization for FG&E's Gas Division was $9,571,224. DTE-RR-6, updated 10/02/02 at Sch-MHC-9 (Gas). These reserves have been reduced by the Depreciation and Amortization Reserve balances related to the Rental Programs and increased by the portion of reserve balances related to Common Plant allocated to the Gas Division. Id.

3. Rate Base Additions

a. Materials and Supplies Inventory

i. Electric Division

FG&E calculated its test year materials and supplies inventory by detailing a thirteen-month average of inventories component in rate base. Exh. FGE-MHC-1 (Electric) at 024, Sch. MHC-10. The inventories component is $771,667 and consists of various materials and supplies used in the transmission/distribution operations. Id. Total Electric Inventories have been reduced by the amounts remaining in inventories during part of the test year related to power production, and by amounts related to the Rental Program. Id.

ii. Gas Division

The thirteen-month average of Inventories calculated into rate base of $373,871 for the Gas Division includes various materials and supplies (including pipe stock) used in the distribution operations, but it does not include gas inventories. Exh. FGE- MHC–1 (Gas) at 20, Sch. MHC-10 (Gas). Inventories for the Gas Division were also appropriately reduced by the amounts related to the Rental Programs. Id.

b. Allowance for Cash Working Capital

Cash working capital is the amount of capital expended and required by FG&E to fund its day-to-day operations and to provide service prior to the payment for such service by FG&E's customers. Exh. FGE-MHC-1 (Electric) at 025; Exh. FGE- MHC–1 (Gas) at 021. Pursuant to Department precedent, cash working capital is an addition to FG&E's rate base. Id.; D.T.E. 98-51 (1998); see also, Boston Edison Co., 53 P.U.R.4th 349 (1983); Boston Gas Co., 49 P.U.R.4th 1 (1982).

The cash working capital allowance initially consists of two components – (1) Purchased Power (for Electric Division) or Purchased Gas (for Gas Division) and (2) Other Operations and Maintenance expense ("Other O&M"). Exh. FGE-MHC-1 (Electric) at 026; Exh. FGE- MHC–1 (Gas) at 21. For Purchased Power Cash Working Capital and for Purchased Gas Cash Working Capital, FG&E conducted two separate lead-lag studies ("PPLead/Lag Study" or "PPStudy", "PGLead/Lag Study" or "PGStudy"). Exh. FGE-MHC-4 (Electric); Exh. FGE-MHC- 4 (Gas); Exh. FGE-MHC–1 (Gas) at 022; Exh. FGE-MHC-1 (Electric) at 026. For Other O&M Cash Working Capital for the Gas Division and for the Electric Division, FG&E used the 45-day convention. Id. D.T.E. 98-51 at 16.

i. Electric Division

FG&E proposed a cash working capital allowance in the Electric Division rate base of $2,653,802. Exh. FGE-MHC-1, Sch. MHC-4 (Electric); D.T.E.-RR-6, updated 10/02/02.

(A) Purchased Power Cash Working Capital

FG&E's Purchased Power Cash Working Capital provides cash working capital for expenses paid by FG&E on customers' behalf to FG&E's Default Service energy suppliers, its Standard Offer Service energy suppliers, and to the providers of External Transmission Services. Exh. FGE-MHC-1 (Electric) at 026. It is appropriate to include cash working capital for this service because the Electric Division's distribution operations continues to be the provider of last resort for customers' energy supply requirements, including making payments for energy supply and for billing, collecting, and financing such costs on behalf of customers that take Default Service, or Standard Offer Service. Id. at 027. There is no recovery mechanism for the required working capital of purchased power in any of FG&E's other unbundled or reconciling rate mechanisms. Id. Accordingly, the working capital requirement for purchased power is appropriately included in the working capital allowance component of the Electric Division's distribution rate base.

Similarly, the Electric Division must ensure that customers receiving supply take and pay for External Transmission service to get the energy to the local distribution grid. Id. Therefore, paying for External Transmission is an Electric Division distribution function responsibility. Id.[12]

FG&E based the PP Lead/Lag Study upon data for the 12 months ended December 31, 2001, adjusted for known and measurable changes. Exh. FGE-MHC-1 (Electric) 028-031. The

---

12 The cost of working capital for external transmission service is not recovered in the Electric Division's External Transmission Charge. See Exh. FGE-MCH-1 (Electric) at 028.

revenue lag and expense lead days resulting from the PP Lead/Lag Study have been applied to adjusted test year purchased power amounts to determine the electric distribution cash working capital requirements. Id. Lag days are the number of days between delivery of a service to FG&E's customers and the receipt by FG&E of payment and availability of funds for the service (revenue lag). Id. Lead days are the number of days between the average delivery date energy is purchased by FG&E or services are rendered by a vendor and the wire/Automated Clearing House (ACH) payment or depository bank clearing date (expense lead). Id.

Revenue lag is computed in days, consisting of four time components: (1) from receipt of electric service to meter reading; (2) from meter reading to billing; (3) from billing to collection; and (4) from collection to receipt of available funds. Exh. FGE-MHC-1 (Electric) at 029. The sum of the days associated with these four lag components is the total revenue lag experienced by the Electric Division. Id.; Exh. FGE-MHC-4 (Electric). For the component "receipt of electric service to meter reading, the PPLead/Lag Study reveals 15.21 days. Exh. FGE-MHC-1 (Electric) at 029. This lag was obtained by dividing the number of days in the test year (365 days) by 24 to determine the average monthly service period. Id.

The component "meter reading to billing" the billing lag is 2.43 days. Id. This lag determines the time required to process the meter reading data and to send out customer bills based on the collected data. Id. The component "billing to collection" lag is 38.61 days, reflecting the time delay between the mailing of customer bills and the receipt of the billed revenues from customers. Id. at 030.

The component "collection to receipt of available funds" lag is 2 days. Id. This check-float period is the lag that takes place during the period from when payment is received from customers to the time such funds clear the bank and are available for use by FG&E. Id. The total revenue lag therefore is computed from these separate lag calculations representing the amount of time between the recorded delivery of service to customers and the receipt of the related revenues from customers. Id.

The lead periods in the PPLead/Lag Study determine the expense lead period. First the monthly expense lead for each vendor is determined by aggregating (1) the average days in the month that the energy or service is received, and (2) the additional billing period up to the wire/ACH payment or bank clearing date. Then the aggregate lead days are weighted. Id. at 31, Exh. FGE-MHC - 4 (Electric). The lag in payment of purchased power costs of 40.51 is subtracted from the lag in receipt of revenue of 58.25 days to produce the total purchased power lag of 17.74 days. Exh. FGE-MHC - 4 (Electric), at 249.

ii. Gas Division

The Gas Division rate base includes an allowance for cash working capital of $703,715 related to Other O&M Expense in distribution rate base. Exh. FGE- MHC – 1 (Gas) at 22; Sch. MHC-4-1 (Gas); DTE-RR-6, updated 10/02/02.

(A) Purchased Gas Cash Working Capital

Purchased Gas Cash Working Capital provides cash working capital for expenses paid by FG&E on customers' behalf to gas suppliers, pipeline transportation providers and supplemental gas providers. Exh. FGE-MHC–1 (Gas) at 022. Purchased Gas Cash Working Capital is recovered as a separate cost component in FG&E’s Cost of Gas Adjustment Clause ("CGAC") tariff. Id. As such, the Purchased Gas Cash Working Capital allowance has been removed from the total cash working capital included in distribution rate base. Id. FG&E intends to update the Purchased Gas Cash Working Capital component of its CGAC for the results of this study in the CGAC compliance filing as part of this proceeding, reflecting an update from 6.8 days to 32.4 days. See id. at 022-23. As described in the PGLead/Lag Study, the primary reason for the increase in the number of days is a change in the billing to collection category in the revenue lag; in FG&E's last base rate proceeding it was 25.9 days, as compared to 49.8 weighted days in the current PGLead/Lag Study. Compare, D.T.E. 98-51, with Exh. FGE-MHC-4 (Gas); Exh. FGE-MHC–1 (Gas) at 023.

The PGLead/Lag Study is based upon data commensurate with the test year, adjusted for known and measurable changes. Exh. FGE-MHC–1 (Gas) at 023. The revenue lag and expense lead days resulting from the PGLead/Lag Study have been applied to adjusted test year purchased gas amounts to determine the Gas Division's CGAC recoverable cash working capital requirements. Id. "Lag days" are computed between FG&E and its customers, and are defined as the number of days between delivery of a service to FG&E's customers and the receipt by FG&E of payment and availability of funds for the service (revenue lag). Id. at 024. "Lead days" are computed as between FG&E and its vendors, and are defined as the number of days between the average delivery date energy is purchased by FG&E or services are rendered by a vendor and the wire/Automated Clearing House (ACH) payment or depository bank clearing date (expense lead). Id.

Revenue lag is computed in days, consisting of four time components: (1) from receipt of gas service to meter reading; (2) from meter reading to billing; (3) from billing to collection; and (4) from collection to receipt of available funds. Id. The sum of the days associated with these four lag components is the total revenue lag experienced by the Gas Division. See Exh. FGE-MHC-4, at 3 of 23; Exh. FGE- MHC–1 (Gas) at 024.

Based on the sums from the four lag components, FG&E's total revenue lag is 68.87 days, representing the time between the recorded delivery of service to customers and the receipt of the related revenues from customers. Exh. FGE-MHC-1 at 026. The separate lag calculation is computed by adding the number of days associated with each of the four revenue lag components, which are then weighted by Firm and Non-Firm gas costs. Id. The lag for the "receipt of gas service to meter reading" component was determined to be 15.21 days. Id. at 024. The "meter reading to billing" component showed billing lags for Firm and Non-Firm sales as 2.43 and 4.77 days, influenced by factors such as contract terms, billing investigation, and the nature of the billing. Id. at 025. The "billing to collection" showed lags for Firm and Non-Firm sales are 49.84 and 20.87 days, reflecting time delays between the mailing of customer bills and the receipt of the billed revenues from customers. Id. The "collection to receipt of available funds" component was 2 days, which recognizes the period from when payment is received from customers to the time such funds clear the bank and are available for use. Id.

To determine the expense lead period, the weighted days lead in payment of purchased gas costs is first determined by the monthly expense lead for each vendor, and then the aggregate lead days are appropriately weighted. See Exh. FGE-MHC-4 at 4 of 23; Exh. FGE-MHC–1 (Gas) at 026. The lead in payment of purchased gas costs of 36.44 is then subtracted from the lag in receipt of revenue of 68.87 days to produce the total Purchased Gas Lag of 32.43 days. See Exh. FG&E-MHC-4 at 5 of 23; Exh. FGE- MHC–1 (Gas) at 025.

iii. Other O&M Cash Working Capital

The Other O&M Cash Working Capital component is composed of the working capital necessary for O&M expense (e.g. payroll, employee and retiree benefits, property taxes[13], income taxes and insurance). Exh. FGE-MHC-1 (Electric) at 31; Exh. FGE-MHC–1 (Gas) at 027. These are types of expenses that FG&E expends to underwrite the business in service to customers before it receives payment from customers for that service. It is appropriate for FG&E to recover its carrying cost. Id. The Department encourages utilities to consider and offer

13 Property taxes, for example, are prepaid 6-12 months ahead. Exh. FGE-2E (Gas).

cost-effective alternatives that produce lower working capital requirements than the 45-day convention, however, it does not want expensive and unnecessary lead-lag studies submitted in rate case proceedings. D.T.E. 98-51 at 15. Therefore, FG&E undertook to determine whether a lead-lag study would be cost justified.

FG&E first issued requests for proposals ("RFPs") to a number of firms to complete both gas and electric O&M lead-lag studies. Exh. FGE-MHC-1 (Electric) at 32; Exh. FGE-MHC-1 (Gas) at 27. Conducting a lead-lag study was determined to cost approximately $200,000. Id. at 28 (Gas) and 33 (Electric). FG&E then analyzed these results and reasoned that undertaking such a study would not be cost-effective. Id. The cash working capital provision produced by the (1) Purchased Power Lead/Lag Study (Exh. FGE-MHC-4 (Electric)), and (2) utilization of the 45-day convention for Other O&M expenses provided the most economic methodologies for providing a fair and reasonable calculation of the Electric Division's cash working capital requirements. Id.

Using the 45-day convention, the Purchased Power Lead/Lag Study and Other O&M computation support the cash working capital component proposed for inclusion in Electric Division distribution rate base of $1,617,141 and $982,660, respectively, which aggregate to a total cash working capital amount of $2,653,802. See Exh. FGE-MHC-1, Sch. MHC-4-1 (Electric), DTE-RR-6, updated 10/02/02. For the Gas Division, the cash working capital component proposed for the inclusion in the distribution rate base is $703,715, related to other O&M expenses. See DTE-RR-6 at Sch MHC-4 (Gas), updated 10/02/02.

iv. Response to Attorney General - Five Issues

The Attorney General contends that the Department previously directed FG&E to seek and consider cost-effective alternatives that produce lower working capital requirements than the 45-day convention and that FG&E has chosen to retain the working capital requirements of the

45-day convention. See AG Br. at 10-11. However, the Department's directive to FG&E states that it "must conduct a lead-lag study or undertake a reasonable, cost-effective alternative to a lead-lad study in order to address the continued validity of the 45-day convention in Fitchburg's case or to propose a different interval." D.T.E. 99-118 at fn. 23 (emphasis supplied).

In this proceeding, FG&E did undertake a third-party-generated lead-lag study and accordingly prepared and issued a Request for Proposal (RFP) for this purpose. Exh. FGE-MHC-1 at 32 (Electric). FG&E received two proposals and, based on these proposals, conducted an analysis to determine the probability that the benefits to ratepayers from performing a lead-lag study would exceed the cost of performing such a study. Id. This analysis showed that the probability of the benefits from performing a lead-lag study exceeding the costs was sufficiently low. Id.

During hearings, the cost-benefit analysis conducted by FG&E received attention. Tr 8/07/02 (Vol. 3) at 367-371; Exh. DTE-2-38 (Common); DTE-RR-10 (Common); DTE-RR-12; DTE-RR-64. Mr. Collin explained that the first bid in the analysis ("Bid 1") was provided by an experienced vendor who, in FG&E's analysis, would have the administrative support and expertise to review and evaluate the vast information required to assemble an O&M Lead/Lag Study. Tr. 8/07/02 (Vol. 3) at 371. This vendor, in FG&E's view, would also make a competent presentation to the Department in both discovery and at hearings. Id. However, this vendor was also the more expensive of the bids received. Exh. DTE-2-38 (Common). The second bid ("Bid 2") was from a less experienced vendor, who had much leaner administrative support and relatively less regulatory expertise. Tr. 8/07/02 (Vol. 3) at 371. While FG&E had concerns about whether an individual consultant would be able to timely and accurately undertake the work required of a full Gas Division/Electric Division O&M Lead/Lag Study, Bid 2 was significantly less in dollar amount and was therefore included in the analysis. Exh. DTE 2-38 (Common).

FG&E's cost benefit analysis gauged the costs of full Lead/Lag on O&M at $200,000. Exh. DTE-2-38 (Common). The benefits were analyzed in view of ratepayers, that is, the likelihood the study would produce a lower combined lag than the 45-day convention, thereby reducing the amount of cash-working capital necessary for inclusion in rates. Id.

The Department made several modifications to the cost-benefit model produced by FG&E. Compare DTE-RR-12 and DTE-RR-64 with Exh. DTE-2-38 (Common). At the last iteration, which modified four factors (amount of bid, years of recovery of cost, level of break-even), Bid 1, preferred on a qualitative grounds, finally reached a probability of 49% (roughly equal to the probability of achieving "heads" on a flip of a coin) in providing greater ratepayer benefits than the 45-day convention. DTE-RR-64. The Department has yet to provide utilities with guidance on the methodology it would like to see used in a cost-benefit analysis of conducting a full O&M expense Lead/Lag Study.

Therefore, based upon the facts as it knew them, FG&E used reasoned decision-making and decided to employ the 45-day convention for Other O&M working capital. Exh. FGE-MHC-1 (Electric) at 032-33; Exh. FGE-MHC-1 (Gas) at 027-28. However, Mr. Collin was very clear that, although FG&E believed that undertaking such a study would not be cost effective for customers, should a study assist the Department in its determination in spite of this finding, FG&E could promptly commission the study. Exh. FGE-MHC-1 (Electric) at 033; Exh. FGE-MHC-1 (Gas) at 028. Based on the proposals received, FG&E estimated that this study would take six weeks to complete, which was within the time that discovery took place in this proceeding. See id. The Attorney General's suggestion that FG&E failed to follow a Department directive in this regard is without merit.

The Attorney General contends that FG&E should not be allowed Revenue Lag days for Purchased Power or Purchased Gas on the following time components (measured in days) (a) meter reading to billing- 2.43 days and (b) collection to receipt of available funds- 2 days. AG Br. at 12. With regard to the meter reading to billing component, the Attorney General asserts that the revenue lag calculation should be zero because the meter read download, the billing generation and the accounts receivable recognition should all occur on the same day. AG Br. at 13. While FG&E continues to make every effort to reduce the time required related to these functions, the Attorney General's position is oblivious to the realities of the actual work involved. There are various inextricably linked processes in the bill preparation process, including checking the data for its validity, accuracy and consistency, as well as the actual preparation of the invoice, which are critical to the function. See Berkshire Gas Co., D.T.E. 01-56 at 52.

The Attorney General, further asserts that the collection to receipt of available funds should be zero, since the payer is obligated to have the funds in the bank account when the check is written. AG Br. at 13. This is an erroneous assumption contrary to good cash management and modern banking practices. A bank customer is only responsible to the bank for a charge against his account at the point the check clears his bank account, as opposed to the day the check is written. Additionally, bank customers today may take advantage of the "float," with at least some number of those customers aware that cash reserve provision are available to meet their banking obligations, if necessary. At the same time, checks deposited in FG&E's bank account may take several days to clear and such funds are not available to FG&E for its use, until the given checks has cleared. Therefore, the Attorney General's claim that a zero lag is appropriate is simply without logic or reason.

Furthermore, the Attorney General has characterized FG&E's methodology for determining its revenue lag as a "back of the envelope" method versus the methodology utilized in the previous electric rate review, D.T.E. 99-118, and asserts that the new methodology overstates the number of revenue lag days. AG Br. at 14. To the contrary, the new methodology is substantially the same methodology utilized by Berkshire Gas in its most recent rate proceeding, which methodology the Department concluded was in accordance with Department precedent. Berkshire Gas Co., D.T.E. 01-56 at 52 (2002). Based upon this and the greater availability to FG&E of relevant data in preparing the current lead-lag studies, the present methodology is superior and more precise than any previous methodology it employed, and a reasonable basis upon which to determine FG&E's cash working capital revenue lag.

4. Rate Base Deductions

a. Reserve for Accumulated Deferred Income Taxes (ADIT) and SFAS No. 109 (FAS 109)

i. ADIT

FG&E initially computed a level of the ADIT that reduced the Electric Division's per books level of rate base, in accordance with Department precedent. Exh. FGE-MHC-1 (Electric) at Sch. MHC-11 (Electric). Sch. MHC - 11 (Electric) shows the detail of the ADIT component of rate base, including the FAS 109 regulatory assets and liabilities, with a total balance of $5,603,855 as at December 31, 2001, the end of the test year. Total Electric ADIT were reduced by the reserves for accumulated deferred income taxes balance related to electric generation to arrive at the portion of ADIT appropriately included in the base rate revenue requirements for the Electric Division. FG&E also computed a level of ADIT that reduced the Gas Division's per books level of rate base under the same precedent. Exh. FGE-MHC-1 at Sch. MHC-11 (Gas). Sch. MHC - 11 (Gas) shows the detail of the ADIT component of rate base, including the FAS 109 regulatory assets and liabilities, with a total balance of $2,596,492 as at December 31, 2001, the end of the test year. Id. Total Gas ADIT were reduced by the reserves for accumulated deferred income taxes balance related to gas supply to arrive at the portion of ADIT included in the base rate revenue requirements for the Gas Division.

Adjustments were then made. First, the Electric Division test year end FAS 109 regulatory assets and liabilities balances were reduced to proform for an amortization for two months in the test year. Exh. FGE-MHC-1 at Sch. MHC-11 (amortization had not commenced as authorized in D.T.E. 99-118).[14] Second, a settlement in D.T.E. 01-103 (pending)[15] filed with the Department on August 22, 2002, established the December 31, 2001 balances for ADIT for the electric generation-related function and, by definition, the remainder amounts as December 31, 2001 balances for ADIT attributable to the Electric T&D function. DTE-RR-43 (reflects Settlement outcome); DTE-RR-6 updated 9/25/02 at Sch. MHC-11 (Electric)(reflects Settlement on other schedules and corrects the T&D ADIT balances). Third, FG&E adjusted for formula-based reallocations between the Electric Division and the Gas Division. DTE-RR-6 updated 10/02/02 at Sch. MHC-11 (Electric), Sch. MHC-11 (Gas) and Sch. MHC-5 (Gas).[16]

The updated Sch. MHC-11 (Electric) shows the details of the ADIT (Credit Balance) component of Electric T&D rate base totaling $5,733,730, including the net FAS 109 Regulatory Asset balance (FAS 109 regulatory asset less liability) of $5,209,484, as of December 31, 2001.

---

14 The adjustment increases the reserve for Electric ADIT in rate base by $43,485.

15 D.T.E. 01-103, was in part a compliance filing from D.T.E. 99-110, that had refined the standards for recovery of regulatory assets and liabilities, and their related deferred income taxes as either Electric generation or T&D (base rate).

16 Reallocated were: FAS 109 Regulatory Asset, the FAS 109 Regulatory Liability and FAS 109 Accounting for Income Taxes.

The updated Sch. MHC-11 (Gas) shows the detail of ADIT (Credit Balance) component of Gas Division distribution and production rate base totaling $3,240,652, including the net FAS 109 Regulatory Asset balance (FAS 109 regulatory asset less liability) of $2,990,862, as of December 31, 2001. DTE-RR-6, updated 10/02/02 at Sch. MHC-11 (Gas) (Electric), Sch. MHC-5 (Gas).

ii. ADIT in 2001 Annual Return

Changes also occurred for the FAS 109 Regulatory Asset, the FAS 109 Regulatory Liability and the total ADIT balances.[17] In the process of preparing responses to information request responses, particularly Exh. AG-7-45 (Electric), FG&E discovered that a discrepancy existed between the amount in the 2001 Annual Return to the Department[18] and the later-filed amounts for these accounts for the Electric Division and the Gas Division in the rate proceedings. The source of the difference was in the allocation methodologies for ADIT (Accounts 190, 282 and 283). In particular, the allocations for the Gas Division rate proceeding and the Electric Division rate proceeding[19] reflected recent Department orders, but the Annual Return reflected the methods used in previous Returns. The revised 2001 Annual Return was filed with the Department. Exh. FGE-Supp-10 at 36D and 36F (corrects the allocation of ADIT ending balances, Accounts 282, 283). An arithmetic error was also corrected. AG-RR-30 (incorrect journal entry for Accounts 253 and 283).[20] Nevertheless, the amounts reflected on

---

17 These changes affected or corrected information filed in (1) FG&E's 2001 Annual Return to the Department and (2) certain FAS 109-related schedules of Exh. FGE-MHC-1 (Gas) and Exh. FGE-MHC-1 (Electric).

18 FG&E's 2001 Annual Return to the Department was prepared in late February and in March for filing at March 31. The report was prepared in a manner consistent with prior years, with review of Department guidelines, prior Department reports and earlier workpapers for guidance. Accordingly, the ADIT were shown in summary fashion, and then allocated to the Gas and Electric Divisions.

19 The Gas Division and Electric Division rate requests were filed May 17, 2002, following a process independent of, and with more rigorous analysis than, the preparation of the annual regulatory filings. Tr. 09/09/02 (Vol. 14) at 1685 (difference between level of analysis for each cost item that precedes a cost-of-service filing, as compared with the per-books review for the Annual Report). Accordingly, the rate filings presented the ADIT in detail by account, including the three accounts for FAS 109 ADIT, the FAS 109 Regulatory Asset and the FAS 109 Regulatory Liability. Exh. FGE-MHC-1 at Sch. MHC-11 (Gas); Exh. FGE-MHC-1 at Sch. MHC-11 (Electric).

20 Carried through, correction of this arithmetic error and a transcription error, which had not been included in the August 9 revision, necessitated a refiling of the Annual Return. Exh. FGE Supp. 9.

schedules filed in the rate proceedings for the FAS 109 Regulatory Assets, FAS 109 Regulatory Liabilities and ADIT remained correct. Exh. AG-7-45 Supplemental (reconciling the amounts to Exh. FGE-MHC-1 at Sch. MHC-11 (Gas); no changes were required on Exh. FGE-MHC-1 at Sch. MHC-11 (Gas) as filed).

FG&E also provided the Department for updated numbers reflecting the D.T.E. 01-103 Settlement. Joint Motion for Settlement, D.T.E. 01-103 (Aug. 2001) (order expected October 15, 2002). If approved by the Department, the Settlement would establish the December 31, 2001 balances for the ADIT for the Electric generation-related function, and by default the December 31, 2001 ADIT balances for the Electric T&D function. DTE-RR-43 (updates the ADIT for the electric generation function from the originally filed Exh. FGE-MHC-1 at Sch. MHC-11 (Electric)); DTE-RR-6 updated 9/24/02 at Sch. MHC-11 (Electric) (updated for the above effects, which changed the electric T&D ADIT balances).[21]

While FG&E continues to hope that these reporting updates have not unduly confused the record, it is confident that the ADIT and FAS 109 amounts for the Gas and Electric Divisions are as set forth in DTE-RR-6 updated 10/2/02 at Sch. MHC-11 (Gas) and Sch. MHC-11 (Electric).

iii. Response to Attorney General - ADIT - Accrued Revenue

The Attorney General argues that FG&E should reduce rate base by an allocated amount that FG&E had excluded from ADIT because the amount was attributable to the over and under collection on FG&E's energy reconciliation mechanisms. AG Br. At 18-19; Tr. 9/6/02 (Vol. 13) at 1580-1581.

As an initial matter, FG&E agrees that Department practice with regard to ADIT has been traditionally to deduct all balances from rate base. Essex Gas Co., D.P.U. 87-59 at 63

---

[21] Gas Division ADIT reallocations were not reflected, but have since been provided to the Department. DTE-RR-6 updated 10/2/02 at Sch. MHC-11 (Electric), Sch. MHC-11 (Gas), Sch. MHC-5 (Gas).

(1987); Commonwealth Elec. Co., D.P.U. 88-135/151 at 14-16 (1989). However, the Attorney General fails to mention that under the unbundled requirements that come from restructuring, the Department has agreed that the portion of the ADIT associated with generation function and gas supply function should be allocated out of the total ADIT so that only that portion associated with distribution operations are included in the revenue requirement. DTE 99-118 at 40; see also D.P.U. 87-59 at 63. The balance, attributable to distribution operations, is applied to the distribution rate base. Id.

Accordingly, in this proceeding FG&E has assigned the appropriate ADIT to its electric and gas distribution function.

b. Customer Deposits

The final item deducted from the Electric Division rate base was for Customer Deposits as of December 31, 2001, the end of the test year. The amount of the deduction is $179,726. Exh. FGE-MHC-1 (Electric) at 035, Sch. MHC-4 (Electric). Likewise a deduction was made from the Gas Division rate base for Customer Deposits as of December 31, 2001, in the amount of $63,419, and in accordance with Department precedent. Exh. FGE-MHC–1 (Gas) at 030, Sch. MHC-4 (Gas).

c. Response to Attorney General - Refundable Customer Advances

The Attorney General incorrectly asserts that FG&E "held" a CIAC balance for both its Electric Division and its Gas Division, and failed to deduct those balances from rate base. AG Br. at 16. The record evidence demonstrates that these are in fact refundable customer advances in the test year end level for the Electric Division of $176,123 and the test year end level for the Gas Division of $269,185 and that they were excluded from rate base. Exh. AG-7-9 (Electric); Exh. AG-5-9 (Gas). According to Department precedent, in the absence of evidence demonstrating a non-representative situation, year-end refundable customer advances are excluded, not deducted, from rate base. See, Berkshire Gas Co., D.P.U. 90-121 at 73-74 (1991); Hingham Water Co., D.P.U. 1590 at 10-11 (1984).

B. OPERATING REVENUE

1. Electric Division Operating Revenue

FG&E proposed two adjustments to operating revenues of the electric T&D operations, related to (1) annualization of the rate decrease in D.T.E. 99-118, effective October 13, 2001; and (2) removal of the Water Heater Rental Program ("Rental Program") revenues from the test year. Exh. FGE-MHC-1 (Electric) at 035. Both adjustments reduce test year operating revenues. Exh. FGE-MHC-1 (Electric) at 035-37.

a. Rate Decrease from D.T.E. 99-118

FG&E has proposed an adjustment of $984,963 to reflect the annualized effect of the rate decrease ordered by the Department in D.T.E. 99-118. In D.T.E. 99-118, the Attorney General claimed that FG&E was overearning relative to a claimed rate of return by more than $3 million; the Department ultimately reduced FG&E's rates by $1.17 million on an annual basis. D.T.E. 99-118, at 93. These rates were effective October 18, 2001. Therefore, in order for operating revenues for the rate year to reflect all known and measurable adjustments to the test year operating revenues, a pro forma determination of the amount of the decrease in revenues was made for the test year period prior to October 18, 2001. Exh. FGE-MHC-1 (Electric) at Sch. MHC-7-1 (Electric).

b. Electric Water Heater Rental Program Revenues

Consistent with Department precedent that revenues and expenses associated with the Rental Program not be included in the revenue requirement for rate-setting purposes, FG&E has proposed an adjustment that decreases operating revenues of the Electric Division by $48,333.

Exh. MHC-1 at 037, Sch. MHC-7-14 (Electric). This adjustment ensures symmetry between expenses and revenues. Id.

c. The Attorney General's Adjustment for Newark America.

The Attorney General misreads the Department's precedent on post test year adjustments in seeking to decrease FG&E's test year revenues based upon Newark America's electric load in four months of 2002. AG Br. at 44-45. In D.T.E. 99-118, the Department allowed an adjustment to FG&E's test year revenues based upon the loss of a large and unique customer (Princeton Paper) that resulted in a significant known and measurable reduction in FG&E's revenues. D.T.E. 99-118 at 16-18. Princeton Paper is clearly distinguishable from Newark America based upon the unique contractual arrangement with FG&E, the size of the load and the fact that the customer declared bankruptcy during the test year and ceased operations entirely prior to the rate year. See D.T.E. 99-118 at 14 and 17-20. The adjustment for Newark America sought by the Attorney General is fundamentally different from the Department's Princeton Paper precedent, because Newark America is a continuing customer whose test year level of service was appropriately reflected in FG&E's operating revenues.

In FG&E's 1999 test year examined by the Department in D.T.E. 99-118, nearly all of FG&E's test year revenues from Princeton Paper were derived from demand charges under two special contracts. D.T.E. 99-118 at 17. Thus, FG&E sought, and the Department approved, an adjustment to test year revenues based upon the complete loss of a customer that was contractually obligated to pay almost all of its test year charges, regardless of usage and without reliance upon a post-test year estimate of load. Id. The demand charges paid by Princeton Paper also represented an extraordinary proportion of FG&E's revenues - almost 30% of FG&E's electrical industrial class operating revenues and 8.4% of total base electric distribution revenues.

Id. at 18. Moreover, the Department found that the loss of Princeton Paper's 18 MW load, representing 20% of FG&E's total demand, was "significant to any reasonable observer." Id.

In this proceeding, the Attorney General seeks to misapply the Princeton Paper precedent to impose a reduction in test year revenues based upon a forecasted load for an existing customer with an uneven load history and an announced intention to explore self generation that could reduce its load on the FG&E system by 40%. See, AG-RR-3 (Confidential). FG&E's filing reflects the test year revenues of Newark America, which purchased some of the facilities of Princeton Paper. Newark America, however, no longer has a special contract arrangement like Princeton Paper, under which the demand charges provide a known and measurable revenue stream. See D.T.E. 99-118 at 14.

In the case of Newark America it is true that there have been post-test year increases in the customer's load. See AG-RR-3 (Confidential); Exh. AG-7-53 (Electric) (Supp.). These post test year loads, however, have been uneven though increasing, varying between 1.4 MVA, in January, and 9.4 MVA in May and 8.4 MVA in September, 2002. Id. The Attorney General's analysis also ignores the fact that Newark America is pursuing self-generation alternatives that would significantly decrease its demand. Instead, the Attorney General seeks to adjust test year revenues based upon Newark America's four months of highest usage in 2002. AG Br. at 45; Tr. 6/1/01 at 300 (D.T.E. 99-118). The Attorney General's proposal is more akin to his assertion in D.T.E. 99-118 that FG&E's test-year revenues be adjusted for a proposed water treatment plant or other new, large customers. D.T.E. 99-118 at 18-19. As in that case, the Department should reject the Attorney General's proposed adjustment because it is neither known and measurable, nor an extraordinary change that is outside the normal "ebb and flow" of customers.

In D.T.E. 99-118 the Department included a post test year adjustment for Newark America revenues, but only as an offset to the removal of Princeton Paper revenues from the test year.

> "However, we do not consider the proposed Newark adjustment as a stand alone adjustment to Fitchburg's test year revenues. . . . The loss of Princeton Paper and gain of Newark are sufficiently related that we can not accept the one and exclude the other."

D.T.E. 98-118 at 19. The Department should not require an adjustment for the Newark America post test year demand in this case because it is not an offset to a pro forma adjustment for a significant loss of test year revenues, as in D.T.E. 99-118. Such an adjustment would be particularly inappropriate given the Company's loss of load in the Newark America customer class (Large General) in the test year. Between 1999 and 2000, FG&E's Large General customer load decreased by 36,000,000 kWh and declined again in 2001 by 20,000,000 kWh. Exh. Attachment DTE 2-9 (Common). To make a post test year adjustment for speculative load growth for one customer would be inequitable and unreasonable given the deteriorating load in the Company's service territory among this customer class.

2. Gas Division Operating Revenues

a. Unbilled Revenue

The Unbilled Revenue adjustment increases test year revenue by $137,958. The purpose of the Unbilled Revenue adjustment is to adjust test year operating revenues to reflect a more accurate calculation of the per books unbilled revenue. Exh. FGE-MHC-1 (Gas) at Sch. MHC-7-1. Due to the nature of the billing cycle process, on a monthly basis FG&E calculates and records unbilled revenues for the current month. The calculation of the unbilled revenues recorded in the test year in the amount of $98,543 is based primarily on the assumption that half of the billing-cycle sales occur in the current month, and the remainder will be billed in the following month.. Tr. 8/12/02 (Vol. 4) at 506; Exh. AG-1-72 (Common); Exh. DTE-6-40 (Gas); Exh. DTE-6-41 (Gas); Exh. DTE-6-42 (Gas); Exh. DTE-6-43 (Gas); Exh. DTE-6-44 (Gas); Exh. DTE-6-45 (Gas); DTE-RR-8. The unbilled revenue adjustment corrects this inaccuracy in the recording of unbilled revenue on the accounting books for the test year based upon this simplified approach by adjusting the test year amount to $39,415 thereby increasing test year unbilled operating revenue by $137, 958. Exh. FGE-JLH-8 (Gas), Workpapers Supporting JLH-5, Pages 159 to 174; Exh. DTE-1-44 (Gas). The calculation of this adjustment was performed and supported by Mr. Harrison, FG&E cost of service expert. See, Exh. FGE-JLH-1 (Gas); Tr.8/12/02 (Vol. 4) at 500-518.

b. Weather Normalization

The weather normalization adjustment increases FG&E's Gas Division base operating revenues by $44,937, while the purchased gas portion of the weather normalization adjustment reduces the gas cost revenue by $2,553. Exh. FGE-MHC-1 (Gas) at Sch. MHC–7-1 (Gas); Tr. 8/06/02 (Vol. 5) at 548-549, Exh. DTE-1-38 (Gas), Exh. DTE-1-39 (Gas); Exh. DTE 6-39 (Gas).

FG&E prepared its cost of service analysis based upon "normal" weather. Consistent with well-established Department precedent, FG&E applied the average degree days over the last 20 years. Exh. FGE-JLH-1 (Gas) at 3; Commonwealth Gas Co., D. P. U. 87-122 (1987); Berkshire Gas Co., D. P. U. 92-210 at 28. Mr. Harrison prepared the weather normalization summarized on Exh. FGE-JLH (Gas) at Sch. JLH-2 (Gas). Mr. Harrison explained that he "computed weighted average actual and normal degree days for each billing month." Exh. FGE-JLH-1 (Gas) at 006. Because some January 2001 billing cycles include December 2000 consumption, a weighted average of the daily degree days was employed. Id. The temperature sensitive portion of each rate class was identified based upon average use per customer in July and August. Exh. DTE-1-44 (Gas). Next, heating load per degree day was calculated by dividing heating load by actual billing cycle degree days. This factor is adjusted by the differences between test year weather and normal weather to derive the weather adjustment sales volumes. Exh. FGE-JLH-1 (Gas) at 007. Finally, "[s]ince the Company's present rates are flat, the volumetric weather adjustment was multiplied by the variable rate in each of the present tariffs to derive the revenue impact." Exh. FGE-JLH-1 (Gas) at 007-8.

c. Gas Water Heater and Conversion Burner Program Revenue

The Gas Water Heater and Conversion Burner Program Revenue adjustment decreases Other Operating Revenues by $411,258. Exh. FGE-MHC-1 (Gas) at 032; Exh. FGE-MHC-1 at Sch. MHC-7-17 (Gas), line 3; Exh. AG-1-33 (Gas), Attachment 1.

The Department previously determined that expense and revenue attributable to Non-Utility Rental Programs may not be included in FG&E's revenue requirements and therefore directed FG&E to place the programs "below the line." D.T.E. 98-51 at 67. This adjustment has been made to remove the actual test year water heater and conversion burner rental revenues from the determination of the Gas Division Other Operating Revenues. Exh. FGE-MHC-1 (Gas) at 032.

d. Gas Lost Base Revenue

FG&E eliminated the test year 2001 revenues related to this recovery of LBR in the amount of $3,888. Exh. FGE-MHC-1 (Gas) at 032 and Sch. MHC-7-2 (Gas). FG&E recovers lost base revenue ("LBR") through the Energy Efficiency Charge ("EEC"). The LBR included in the test year was calculated and recorded in accordance with the Department's rolling period method. Exh. FGE-MHC-1 (Gas) at 032.

This adjustment is appropriate to recognize that FG&E will no longer recover these LBR revenues on previously installed energy efficiency measures. Exh. FGE-MHC-1 (Gas) at 033. When the rates in this proceeding are set, LBR associated with energy efficiency measures will be built into FG&E's gas base rates, which will be established based on the test year level of billing determinants that reflect the reduction in sales due to installed energy efficiency measures. Exh. FGE-MHC-1 (Gas) at 033.

e. Purchased Gas Cash Working Capital and IFC Revenues

The Purchased Gas Cash Working Capital and Inventory Finance Charge ("IFC") are two components of the FG&E's CGAC that recover the carrying cost related to Purchased Gas and Gas Supply Inventories. Exh. FGE-MHC-1 (Gas) at 033. These items were previously authorized by the Department for recovery through the CGAC and are excluded from the revenue requirements analysis. Exh. FGE-MHC-1 (Gas) at 033. The amount of the reduction from test year revenue is $22,437. Exh. FGE-MHC-1 (Gas) at 033 and Sch. MHC-7-3 (Gas).

C. OPERATING & MAINTENANCE EXPENSE

1. Introduction

In the test year, FG&E incurred $7,545,924 in Electric Division O&M Expense. Exh. FGE-MHC-1 at Sch. MHC - 3 (Electric). Mr. Collin made pro forma adjustments to the test year amounts for the Electric Division, which amount was increased through corrections and updates during the proceeding by $424,544 to $7,970,468. DTE RR-6 (Electric), updated 10/02/02 at Sch. MHC-7 (Electric).

In the test year, FG&E incurred $5,724,453 in Gas Division O&M Expense. Exh. FGE-MHC-1 at Sch. MHC–3 (Gas). After recognizing corrections/adjustments to the Gas Division revenue requirements from filing through discovery, pro forma adjustments to the test year O&M expense amounts for the Gas Division reduced that amount by $16,545 to $5,707,908. DTE-RR-6 (Gas), updated 10/02/02 at Sch. MHC-7 (Gas).

FG&E will include any additional updates, pursuant to Department precedent, in its Reply Brief of October 24, 2002. See e.g. DTE RR-6 (Gas) updated 9/24/02.

2. Adjustments to Test Year O & M

An adjustment to other power supply expense was initially made to FG&E's test year Electric Division O&M, but was subsequently removed from the pro forma adjustments. Two adjustments particular to the test year Gas Division O&M expense were made to amortize the deferred farm discount credit and to adjust test year legal expense.

Adjustments in areas common to both the Electric Division and the Gas Division were Payroll, Medical and Dental, Pension, Post-employment Benefits Other than Pension (PBOP), Property and Liability Insurance, Bad Debt/Uncollectible, USC Service Charge, Advertising/Promotions, Gas/Electric Allocations, Inflation, Rate Case Expense, Adjustment for Non Utility Plant ("Rental Program"), Operating Lease, Payroll Tax, Property Tax, Depreciation Expense, and Amortization Expense.

a. Other Power Supply (Electric)

In its initial filing, FG&E removed from Electric Division test year O&M expenses amounting to $32,412 associated with Account 555 (FERC), as they were identified as a power supply cost and believed to be incorrectly charged to distribution operations. Exh. FGE-MHC-1 at Sch. 7-2 (Electric). Upon further review, FG&E determined that these costs are not recovered in any of the Company's other unbundled rates such as the various rate reconciliation mechanisms. D.T.E. 99-110 at 27; Exh. DTE-2-19. Accordingly, FG&E requests that the amount originally deducted from Electric Distribution O&M expense be reinstated as a legitimate cost of service FG&E's Electric Division distribution customers. D.T.E. 99-110 at 27; Exh. DTE-2-19; DTE-RR-6, updated 10/02/02 at Sch. ADJ, line 10, updated Sch. MHC-7-19 (Electric).

b. Amortization of Deferred Farm Discounts (Gas)

FG&E has deferred recovery of revenue discounts granted to qualified farm customers under the law, and at March 31, 2002, the deferred balance was $7,424. Exh. FGE-MHC-1 at Sch. MHC–7-4 (Gas). The pro forma adjustment based on the deferred balance at March 31, 2002 to the Gas Division's test year revenue requirements is $1,061. Exh. FGE-MHC-1 at Sch. MHC–7-4 (Gas).

Under St. 1997, ch. 164, the General Court granted rate reductions to farms in the form of a Farm Discount applicable to all gas and electric distribution companies in the Commonwealth. Exh. FGE-MHC-1 (Gas) at 035. In D.T.E. 98-51, the Department authorized FG&E to propose in its next rate case the recovery of deferred amounts of revenue discounts available to qualified farm customers. D.T.E. 98-51 at 149. FG&E has been deferring such discount credits since December, 1998. Exh. FGE-MHC-1 (Gas) at 035.

FG&E proposes to amortize this amount over a seven-year period consistent with the proposed amortization period for the current rate case costs. Exh. FGE-MHC-1 (Gas) at 035. The Attorney General argues that the deferred balance should be amortized over the life of the PBR Plan adopted by the Department for FG&E. See AG Br. at 78. The Department has not approved a PBR Plan for FG&E. Therefore, even if the Attorney General's proposal had merit, it is without evidentiary basis on this record. Accordingly, FG&E requests that the Department approve the rate treatment it proposes for this deferral.

c. Test Year Legal Expense (Gas)

FG&E proposes an adjustment to reduce test year Legal Expense for the Gas Division by $195,864. Exh. FGE-MHC-1 at Sch. MHC-7-11 (Gas). Non-recurring expenses that are not extraordinary are not includible for determining rates. Therefore, the legal cost incurred in the test year relative to FG&E's defense in D.T.E. 99-66 is appropriately removed from test year Legal Expense. Exh. FGE-MHC-1 (Gas) at Sch. MHC-7-11 (Gas).

d. Payroll (Common)

The payroll adjustment increases the test year payroll charged to Electric Division O&M by $103,418. DTE RR-6, updated 10/02/02; Exh. MHC-1 (Electric) at Sch. ADJ (Electric) line 1, and Sch. MHC-7-3 (Electric). The payroll adjustment increases the Gas Division test year payroll by $107,379. DTE-RR-6 (Gas) updated 10/02/02; Exh. FGE-MHC-1 (Gas) at Sch. ADJ (Gas), Line 1, and Sch. MHC–7-5 (Gas). The adjustment relates to known and measurable changes to payroll expense that will occur during 2002 and 2003, up to the midpoint of the rate year. FGE-MHC-1 (Electric) at 039; Exh. FGE-MHC-1 (Gas) at 036.

The payroll adjustments for both the Electric Division and the Gas Division reflect the known percent payroll rate increases for 2002 and 2003, separately by union and non-union categories, to the Electric Division's O&M payroll and to the Gas Division's O&M payroll for the test year. Exh. FGE-MHC-1 (Electric) at 039-040; Exh. FGE-MHC-1 (Gas) at 036; DTE-RR-6 (Electric) updated 10/02/02 at Sch. MHC-7-3 (Electric); DTE RR-6 (Gas) updated 10/02/02 at Sch. MHC-7-5 (Gas). All payroll amounts charged to capital and non-utility are removed and excluded from this adjustment. Exh. FGE-MHC-1 (Electric) at 040; Exh. FGE-MCH-1 (Gas) at 036.

i. The Department's Standard for Payroll Adjustments

The Department requires that post- test year wage and salary adjustments be known and measurable. See, Berkshire Gas Co., D.P.U. 92-210 at 31; Massachusetts Elec. Co., D.P.U. 92-78 at 78 (1992); Bay State Gas Co., D.P.U. 92-111 at 97-98 (1992). In order for adjustments to be known and measurable they must take place before the midpoint of the twelve months following issuance of the Department's Order and, in the case of union payroll increases, they must be based on signed contracts between the union and the utility. Berkshire Gas Co., D.P.U. 92-210 at 31; Bay State Gas Co., D.P.U. 92-111 at 97-98. In deciding the propriety of prospective non-union wage adjustments, the Department invokes a three-part standard: there must be (1) an express commitment by management to grant the increase; (2) an historical correlation between union and non union raises; and (3) an amount of increase that is reasonable. See, Berkshire Gas Co., D.P.U. 92-210 at 35-36; Bay State Gas Co., D.P.U. 92-111 at 102.

ii. Union Salaries

The percent increases for union for 2002 and 2003 are based on the current contract that is in effect through May 31, 2005. Exh. AG-1-42 (Common); Exh. FGE-MHC-1 (Electric) at 040; Exh. FGE-MHC-1 (Gas) at 036. The annual effective date of union increases is June 1. Exh. AG-1-43 (Common); Exh. FGE-MHC-1 (Electric) at 040; Exh. FGE-MHC-1 (Gas) at 036-037.

Both of FG&E's 2002 and 2003 union payroll increases are known and measurable and related to a signed union contract. Exh. AG-1-42 (Common). FG&E's union wage rates are established periodically through a collective bargaining process. Exh. FGE-MHC-1 (Gas) at 041; Exh. FGE-MHC-1 (Electric) at 44. As part of this process, FG&E reviews contracts from as many utilities in New England as possible in order to reasonably calculate competitive wage rates for each position. Exh. FGE-MHC-1 (Gas) at 041; Exh. FGE-MHC-1 (Electric) at 44. This process helps set fair and equitable wage rate goals in the collective bargaining process to ensure that union salaries attract and retain qualified personnel. Exh. FGE-MHC-1 (Gas) at 041; Exh. FGE-MHC-1 (Electric) at 044. In 1999, FG&E performed a survey of hourly wage rates for FG&E compared to 28 other gas and electric utilities in New England and New York. Exh. FGE-MHC-1 (Gas) at 041; Exh. FGE-MHC-1 (Electric) at 044. The results of that survey indicated that the FG&E hourly rates paid union employees were comparable, and in some cases below, the average hourly rates of FG&E's peers. Exh. AG-5-15 (Gas).

iii. Non-Union Salaries

With regard to non-union increases, the known 2002 increase took effect on January 1. Exh. FGE-MHC-1 (Gas) at 037; Exh. FGE-MHC-1 (Electric) at 040; Exh. AG-1-43 (Common). Within 30 days of the rate order in this proceeding, another non-union increase will take effect for 2003. Exh. FGE-MHC-1 (Gas) at 037; Exh. FGE-MHC-1 (Electric) at 040. FG&E has, in compliance with Department precedent, demonstrated that there is an historical correlation between union and non-union wages. Exh. AG-1-41 (Common). In addition, FG&E has provided evidence of management's commitment to implement 2003 non-union adjustments.[22]

FG&E has a process in place to continually benchmark its compensation against industry peers with the goal of attracting and retaining qualified employees. Mr. Collin further indicated that a review of compensation and benefits levels should be done, in good business judgment, at regular intervals to ensure a company's wages properly reflect market conditions. Tr. 8/23/02 (Vol. 11) at 1352.

In response to concerns of high turnover in 1997, FG&E commissioned The Hay Group, an internationally-recognized expert in the area of compensation, to assist it in evaluating its wage and compensation structure. Tr. 8/23/02 (Vol.11) at 1351; Exh. FGE-MHC-1 (Gas) at 037; Exh. DTE-4-5 (Common)(Confidential) (1998 Hay Group Study); AG-RR-7; Exh. FGE-MHC-1 (Electric) at 041. The study of FG&E's and its affiliates' salaries and benefits was undertaken for the express purpose of comparing these salaries and benefits to appropriate external markets. Exh. FGE-MHC-1 (Gas) at 037-038; Exh. FGE-MHC-1 (Electric) at 041. Hay assisted in evaluating executive positions, reviewing internal equity of all job evaluations, setting

[22] Exh. FGE-Affidavit, filed 10/02/02.

competitive salary ranges and establishing a program for administering salary increases. Exh. FGE-MHC-1 (Gas) at 038; Exh. FGE-MHC-1 (Electric) at 041; Exh. DTE-4-5; Exh. AG-RR-7 Supplemental (Confidential).

Hay used its own extensive database of over 1,000 companies that participate in their annual salary and benefit surveys. Exh. FGE-MHC-1 (Gas) at 038; Exh. FGE-MHC-1 (Electric) at 041. In addition, Hay used surveys published by other nationally known consulting firms to double-check the competitiveness of positions that they were evaluating for Unitil. Exh. FGE-AG-5-12 (Gas). Ultimately, Hay recommended a policy of paying at the median for base pay, total cash compensation, and total compensation when compared to all companies in general industry with less than $1B in annual revenues. Exh. FGE-MHC-1 (Electric) at 041; Exh. FGE-MHC-1 (Gas) at 038. Hay did not use smaller companies with annual revenues akin to that of Unitil or FG&E because, in its expertise, it found there was not a noticeable difference in pay levels in order to attract and retain qualified employees. Exh. FGE-MHC-1 (Electric) at 041; Exh. FGE-MHC-1 (Gas) at 038. In addition, they found that median pay levels in New England are roughly equal to median pay levels nationwide. Id.

Hay concluded that FG&E's cash compensation (base pay plus incentives) was very low when compared with the markets for utilities, general industry, New England and nation-wide. Exh. FGE-MHC-1 (Gas) at 039; Exh. FGE-MHC-1 (Electric) at 042. In most cases, FG&E's cash compensation was below the 10th percentile (near the bottom of the market). Exh. FGE-MHC-1 (Gas) at 039; Exh. FGE-MHC-1 (Electric) at 042.

Because Hay found that, compared to the market, FG&E salary ranges were very low and too closely packed together, it recommended salary ranges that would come closer to the median and that would reward employees when they render valuable service to FG&E and its customers.

Exh. FGE-MHC-1 (Gas) at 039; Exh. FGE-MHC-1 (Electric) at 042. Hay also recommended that FG&E consider a broad-based cash incentive plan to improve the competitiveness of our total cash compensation. Exh. FGE-MHC-1 at 039; Exh. FGE-MHC-1 (Electric) at 042.

As a result of the Hay Compensation Study FG&E has been on a planned program of moving its salary ranges and base salaries to a more competitive position since 1998. Exh. AG-7-58 (Gas, Electric). Faced with the Hay Group Study, FG&E's choice in 1998 was to spend a large amount of money all at once to increase the pay for many positions, or to phase in the higher ranges and base pay over a period of years. Exh. FGE-MHC-1 (Gas) at 039; Exh. FGE-MHC-1 (Electric) at 043. FG&E implemented the latter approach, moving its ranges on a planned basis to get them closer to the median and FG&E continues to benchmark its progress to ensure that its salaries and compensation remain competitive with the market. Tr. 8/23/2002 (Vol. 11) at 1363.

As explained in Mr. Collin's direct testimony, because of the need to become competitive in order to retain and attract qualified employees, base salary increases have been 1% to 2% higher than average since 1998, in order to bring salaries in line with the market. Exh. FGE-MHC-1 (Gas) at 040; Exh. FGE-MHC-1 (Electric) at 43. In addition, compensation includes an annual cash incentive program that provides a target payout of 5% of base salary if certain goals set each year by the Board of Directors are met. Exh. FGE-MHC-1 (Gas) at 040; Exh. FGE-MHC-1 (Electric) at 043; Exh. AG-1-35; Exh. DTE-4-7; Exh. DTE-4-8; Exh. DTE-4-9. These goals include customer satisfaction, safety and reliability, and cost containment. Exh. FGE-MHC-1 (Gas) at 040; Exh. FGE-MHC-1 (Electric) at 43.

FG&E participates in several salary surveys each year to verify that the data from the Hay Group continues to be a valid measure of median base pay and salary ranges in the utility industry and in New England. Exh. FGE-MHC-1 (Gas) at 040, Exh. FGE AG-5-13 (Gas); Exh. FGE-MHC-1 (Electric) at 043. For example, in 2001, FG&E performed a benchmark analysis of five Professional/Technical and Managerial jobs, which compared the 2001 FG&E midpoint for those five job grades to the 2001 Hay Survey Median. Exh. FGE AG-5-14 (Gas). On average, FG&E was below the survey median by $3,623. Exh. FGE-MHC-1 (Gas) at 040; Exh. FGE-MHC-1 (Electric) at 043. For two positions (Administrative Assistant and Director/Distribution Operations Center), the FG&E salary midpoint was below the survey by $6,350, and for the remaining three positions, the FG&E midpoint exceeded the median by $2,727. Exh. FGE-MHC-1 (Gas) at 040; Exh. FGE-MHC-1 (Electric) at 043-044.

iv. Response to Attorney General

The Attorney General argues that the Department should disallow the entire proposed non-union wage increase. He begins his argument by claiming, in error, that FG&E has requested a wage increase of $210,797. AG Br. at 28. In fact, the evidence is that FG&E seeks a non-union increase of $45,902 for the Gas Division and $44,209 for the Electric Division for a total proposed increase of $90,111. DTE-RR-6, updated 10/02/02 (Gas) (Electric), Exh. FGE-MHC-1 (Gas) at Sch. MHC-7-5 (Gas); Exh. FGE-MHC- 1 (Electric) at Sch. MHC-7-3 (Electric).

The Attorney General's argument for disallowance is flawed. The Attorney General claims that the 1997 Hay surveys and 1998 Hay Study use compensation packages from organizations that generate over $1 billion dollars in annual revenues and therefore are not comparable to FG&E or Unitil. AG Br. at 030. The Attorney General however, is not clear with the record evidence. The 1998 Hay Total Remuneration Audit clearly states on page 1 that the comparison group is comprised of "Industrial Organizations with Less than $1 Billion in Sales." AG-RR-7; Exh. FGE-Surveys; Exh. D.T.E. 4-5 (Common)(Confidential).

The core of the Attorney General's argument for disallowance is that "[a] careful review of the 1997 Hay Study upon which FG&E relies show that FG&E's total wage and benefit package greatly exceeded the industrial and utility averages for the year." AG Br. at 30. Once again, the Attorney General's position indicates a basic lack of understanding about the use and reading of the surveys. The Total Remuneration (salary plus benefits) summary clearly shows that FG&E, in 1997, was grossly below the median. Exh. D.T.E. 4-5 (Common)(Confidential), Total Remuneration Table at 11. Indeed this analysis shows FG&E in the bottom quarter of the market for most job levels. Id. On the pages labeled "Base Compensation," "Total Cash Compensation," and "Total Benefits Values," the study further shows that the reasons for this weak market position were very low salaries and no incentive plan, offset somewhat by moderately high benefits. Id. at 12-14; Exh. FGE-MHC-1 (Gas) at 039; Exh. FGE-MHC-1 (Electric) at 042.

To rebalance FG&E's total compensation practices, FG&E began a program of increasing base pay by a small amount (between 1 and 2%) above annual average pay increases and adopted an annual cash incentive program. Exh. FGE-MHC-1 (Gas) at 040; Exh. FGE-MHC-1 (Electric) at 043; Exh. AG-1-35; Exh. DTE-4-7; Exh. DTE-4-8; Exh. DTE-4-9. Further FG&E took numerous steps in reducing its health care costs. Exh. AG-1-52 (Common). FG&E therefore adopted a course of action squarely in line with the Attorney General's recommendation of offsetting salary increases with reduced benefits. AG Br. at fn. 26.

While the Attorney General position is focused on an erroneous critique of the Hay Group Study benchmarking analysis (AG Br. at 30), his argument omits the record evidence that demonstrates FG&E's use of other salary surveys to verify the forward-looking results of the 1998 Hay Study. Exh. FGE-MHC-1 (Gas) at 040; Exh. FGE-MHC-1 (Electric) at 043; Exh.

FGE-Surveys; AG-RR-7. These surveys show that on average FG&E's salary ranges continued to be below median when compared to electric and gas utility companies, particularly when compared to other investor-owned utilities in New England. Exh. AG-5-14 (Gas). Further, the Towers-Perrin and American Gas Association surveys were two of the surveys that the Hay Group also used in 1997 to conclude that FG&E's pay levels were low when compared to the market. AG RR-7 (Confidential).

Finally, the Attorney General complains that FG&E's position is weakened because no representative from the Hay Group was available for cross examination. AG Br. at 28. The record demonstrates that Mr. Collin had direct information about the background to, and the implementation, of the Hay Group recommendations in 1998 and was available for cross examination. He proved to be a competent witness on compensation matters and on the Department's precedent in this area. Mr. Collin informed the Department that the recommendations from Hay Group were forward-looking. He testified that the recommendations had proven to be in line with comprehensive human resources market information for salaries and compensation, not only the year they were adopted (supported by other evidence in the record as well), but in the test year and the rate year, which are the only years for which the Department is setting rates. Tr. 8/23/02 (Vol. 11) at 1344-1355; Tr. 8/23/02 (Vol. 11) at 1362-1363. Finally, this unnecessary expense was not requested by the Attorney General prior to submitting his brief, nor did the Attorney General provide any inkling of an offer of proof sufficient to warrant the burden and expense of an additional outside witness at any relevant time during this proceeding.

The Attorney General's analysis of FG&E's salary and benefits structure and programs is inaccurate and not supported by the record evidence. On the other hand, FG&E has demonstrated that its adjustments meet the Department's standards in this area. Accordingly, FG&E requests the Department grant its pro forma payroll adjustment in this proceeding.

e. Health Care Expense (Common)

FG&E proposes an adjustment to test year Medical and Dental Insurance costs to reflect known and measurable increases that were experienced in 2002. Exh. FGE-MHC-1 (Electric) at 044; Exh. FGE-MHC-1 (Gas) at 041. The proposed increase to test year Electric Division O&M is $22,729. The adjustment increases test year Gas Division O&M expense by $37,844. Exh. FGE-MHC-1 (Gas) (Electric) at Sch MHC-7-6 (Gas) and Sch. MHC-7-4 (Electric).

The Department requires that health care expenses and post-test year adjustments to health care expense be (1) known and measurable, and (2) reasonable in amount. Boston Gas Co., D.P.U. 96-50 (Phase I) at 45-46 (1996); North Attleboro Gas Co., D.P.U. 86-86 at 8 (1986). In addition, the Department requires companies to demonstrate that they have acted to contain their health care costs, in a reasonable, effective manner. Berkshire Gas Co., D.T.E. 01-56 at 60 (2002); Boston Gas Co., D.P.U. 96-50 (Phase I) at 46; Massachusetts Elec. Co., D.P.U. 92-78 at 29 (1992); Nantucket Elec. Co., D.P.U. 91-106/138 at 53 (1991). In accordance with Department precedent, FG&E is seeking adjustments to test year medical and dental expense for 2002 based upon known employee enrollments in January 2002, and related employee contributions and rates effective for 2002. Exh. FGE-MHC-1 (Gas) at 042. Exh. FGE-MHC-1 (Electric) at 045.

As the cost of Medical and Dental Insurance is initially borne by FG&E as a common expense to both the Electric Division and the Gas Division, the adjustment calculates the allocated cost attributable to each Division. Exh. FGE-MHC-1 (Electric) at 046; Exh. FGE-MHC-7-4 (Electric), line 9; Exh. FGE-MHC-1 (Gas) at 043; Sch. MHC-7-6 (Gas), line 9. The Medical and Dental Insurance expense allocated thereby is then reduced by the amount chargeable to capital. Exh. FGE-MHC-1 (Electric) at 046-047; Exh. FGE-MHC-7-4 (Electric), line 10; Exh. FGE-MHC-1 (Gas) at 043; Sch. MHC-7-6 (Gas) line 10. The resulting amount is the O&M Expense. Finally, the test year Medical and Dental Insurance expense is subtracted from the O&M expense, to derive the pro forma adjustment of $22,729 for the Electric Division and $37,844 for the Gas Division. See Exh. FGE-MHC-1 (Electric) at 047; Exh. FGE-MHC-1 (Gas) at 044; Exh. FGE-MHC-1 (Electric) at Sch. MHC - 7-4 (Electric), line 13; Sch. MHC-7-6 (Gas) line 13.

Medical and Dental Insurance is based on three factors: the rates effective for 2002, the employee enrollment in January 2002 and the related employee contributions. Exh. FGE-MHC-1 (Electric) at 045; Exh. FGE-MHC-1 (Gas) at 042. Each of FG&E’s insurance providers increased the working rates after the test year. Id. The amount included in the revenue requirement, therefore, is based on known and measurable changes to the test year health care cost, as required by the first prong of the Department's standard.

Furthermore, FG&E's test year expenses and adjustments are reasonable in light of its aggressive cost containment efforts and demonstrated success in cost containment. See Exh. FGE-MHC-1 (Gas) at 042-043; Exh. FGE-MHC-1 (Electric) at 045-046. As Mr. Collin stated, FG&E continually compares the coverage of its insurance programs as compared to the premiums paid, and the coverage and cost versus the market alternatives. Exh. FGE-MHC-1 (Gas) at 042; Exh. FGE-MHC-1 (Electric) at 045; Tr. 8/23/02 (Vol. 11) at 1387. This review is conducted for FG&E individually and as part of the Unitil System, to ensure that the value for the cost of insurance is maintained, and that costs are contained as much as feasible. Id. Mr. Collin also explained that FG&E joined purchasing power with Unitil and its affiliates in 1995 in order to obtain more competitive rates from its carriers. Id.; Exh. FGE AG-1-52 (Common).

In 1999, FG&E began to require non-union employee contributions to premium payments, in order to help offset cost increases. Id.; Exh. FGE-MHC-1 (Electric) at 045-046; Exh. FGE-MHC-1 (Gas) at 042-043; Tr. 8/23/02 (Vol. 11) at 1402. Contributions were required of union employees beginning in 2000. Exh. FGE-MHC-1 (Gas) at 042-043, Exh. FGE AG-1-52 (Common); Exh. AG-5-31 (Common); Exh. FGE-MHC-1 (Electric) at 046. FG&E also instituted an "opt-out" program that permits and encourages employees to become insured elsewhere (e.g. spouse employer). Exh. FGE-MHC-1 (Gas) at 043, Exh. AG-1-52 (Common); Exh. FGE-MHC-1 (Electric) at 046. On January 1, 2001, FG&E converted from a fully-insured plan to a self-insured plan to save money previously paid to insurance companies for margin, profit, taxes, administration and retention. Exh. FGE-MHC-1 (Gas) at 043; Exh. FGE-1-52 (Common), Exh. AG-5-23 (Common); Exh. FGE-MHC-1 (Electric) at 046. As further explained by Mr. Collin:

> Similar to what we do on our casualty and property insurance, we also retain a broker to assist us in renewals of our health and welfare programs; and that broker would provide us advice and essentially guidance and consulting services with regard to any renewal quote that we would receive from the market.

Tr. 8/23/02 (Vol. 11) at 1399.

The result of this continuing attention to health care cost containment has resulted in average cost per employee falling from 2000 to the test year 2001. Exh. AG-1-51 (Common); Tr. 8/23/02 (Vol. 11) at 1401. Further, total medical and dental insurance costs decreased from 1992 to the test year 2001. Exh DTE 1-30 (Gas, Electric, Common). Accordingly, in accordance with Department precedent, FG&E has taken a number of reasonable, effective steps to contain its health care expense. See Eastern Edison Co., D.P.U. 93-60 at 128 (1993); Berkshire Gas Company, D.P.U. 92-210 at 43-44 (1993).

The Attorney General argues that the proposed increase in medical and dental expense reflects a 26% increase in projected costs for medical claims, that this estimate has not been updated with actuals, and that, due to this estimate, the Department should adopt an 11% percent increase based upon the estimates contained in the PBOP actuarial report. AG Br. at 35-36. The Attorney General's argument is flawed on numerous counts.

First, the Attorney General is wrong about the percentage increase of FG&E's request for adjusted medical and dental expense. The total 2002 increase as requested is $60,573, comprised of $22,729 for the Electric Division and $37,844 for the Gas Division. This is a 21% increase over the combined test year 2001 expense of $291,054. Exh. FGE-MHC- 1 (Electric) at Sch. MHC-7-3 (Electric); Exh. FGE-MHC-1 (Gas) at Sch. MHC-7-5 (Gas).

Next, the Attorney General's claims that FG&E has not substantiated its medical expense increase are incorrect. AG Br. at 35. These costs are known and measurable and FG&E has submitted year-to-date medical expense through July 31, 2002 that substantiate FG&E's 2002 expenses. DTE-RR-63. Should the Department deny FG&E's proposed adjustment under its self-insurance program on the basis of the Attorney General's claims, the Department's long-standing policy to encourage lower health costs for employees of Massachusetts utility companies by pursuing innovative cost containment will falter. Companies will be discouraged from investing in innovative approaches to cost containment where its risk surely leads to denial of known costs in rates.

The proposed health care expense for the Electric Division and Gas Division is reasonable for inclusion in rates and should include the proformed adjustment. The renewal for 2003 demonstrates that, based on FG&E's claims experience through July 2002, FG&E will experience an additional 26.7% increase in premium costs for 2003 for which FG&E has not yet requested recovery. DTE-RR-63. This update would be appropriately included in the Department's determination of FG&E's revenue requirement. Berkshire Gas Co., D.T.E. 01-56 at 60 (2002).

The Attorney General's argument to that the Department adopt the estimated 11% increase contained in the PBOP actuarial report is flawed. The actuary's projection of medical trend rates was developed in 2001 and was used for forward-looking, long-term estimation of future expenses. The 21% increase in actual claims is a known and measurable amount that Fitchburg has already experienced for the first seven months of 2002. There is no basis of comparison between past experience for one year and future expectations for multiple years.

Last, the Attorney General incorrectly states that Anthem BC/BS charges a fee for services which is based on claims paid. AG Br. at 35. Anthem's fee is not based on claims paid and the Attorney General has confused the record he cites. It does not support his claim. Tr. 8/19/02 (Vol. 8) at 971-972. Anthem's fee is a fixed amount per-person per-month based on coverage selected and this fixed amount is included in the working rates. Exh. FGE MHC-2A (Gas); Exh. FGE-2B (Electric).

Accordingly, in accordance with Department precedent, FG&E has taken a number of reasonable, effective steps to contain its health care expense. See Eastern Edison Co., D.P.U. 93-60 at 128 (1993); Berkshire Gas Co., D.P.U. 92-210 at 43-44 (1993). FG&E's pro forma adjustment should be permitted and the Attorney General's speculation should be dismissed.

f. Pension (Common)

FG&E's pension adjustment seeks to increase Electric Division test year pension expense by $105,778, and, likewise, the proposed adjustment would increase Gas Division test year pension expense by $80,189. Exh. FGE-MHC-1 (Electric) at Sch. MHC-7-5 (Electric); Exh. FGE-MHC-1 (Gas) at Sch. MHC-7-7 (Gas).

The Department has stated that it does not endorse any specific method for the calculation of pension expense for ratemaking purposes and that the intricacies of this issue warrant investigation on a case-by-case basis. Boston Gas Co., D.P.U. 96-50 (Phase I) at 80 (1996), citing Mass-American Water Co., D.P.U. 95-118 at 111 (1995); Massachusetts Elec. Co., D.P.U. 95-40 at 44 (1995); Massachusetts Elec. Co., D.P.U. 92-78 at 46 (1992). The Department has found that where a utility is making cash contributions to the pension funds, irregardless of the accounting calculation of pensions, those contributions should be included in the cost of service. Boston Gas Co., D.P.U. 96-50 (Phase I) at 80-81; Mass-American Water Co., D.P.U. 95-118 at 111. Where a company went from an overfunded pension position to a position where it was required to make contributions to pension funding between rate cases, the Department has denied any attempt to carry deferred pension contributions for recovery in subsequent rate proceedings. Mass-American Water Co., D.P.U. 95-118 at 112-113.

Currently, the pension funds attributable to FG&E are in an over-funded position relative to future pension liabilities. Exh. FGE-MHC-1 (Electric) at 047; Exh. FGE-MHC-1 (Gas) at 044. FG&E does not, therefore, make cash contributions, and has not since 1997. Exh. FGE-MHC-1 (Electric) at 047; Exh. FGE-MHC-1 (Gas) at 044, Exh. MHC-2B (Gas); Exh. MHC-2C (Electric); Exh. DTE-4-1 (Gas, Electric, Common). Because FG&E's revenue requirement does not include pension expense, but FG&E will be required to fund the pension expense in the future without rate recovery, FG&E believes it is appropriate to remove from the cost of service the per books amount recorded in the test year attributable to the Electric Division and the Gas Division pension income.

g. Post-employment Benefits Other Than Pension ("PBOP") (Common)

The pro forma adjustment increases Electric Division PBOP O&M expense by $54,556 for costs to be experienced in 2002. DTE RR-6, updated 10/02/02; Exh. FGE-MHC-1 (Electric) at Sch. MHC-7-6 (Electric). The pro forma adjustment increases Gas Division PBOP O&M expense by $11,513 for costs to be experienced in 2002. DTE RR-6 (Gas) updated 10/02/02; Exh. FGE-MHC-1 (Gas) at Sch. MHC-7-8 (Gas).

The Department has found that funding tax-deductible amounts placed in trusts specifically designed to provide for the payment of employee PBOPs provides assurance that the funds provided by ratepayers will be safeguarded and retained for employee benefits. Mass-American Water Co., D.P.U. 95-118 at 105 (1995), Massachusetts Elec. Co., D.P.U. 92-78 at 83. This method, the Department has found, provides incentives to take advantage of the tax benefits to lower overall PBOP expense. Id. The Department has accepted reasonable actuarially-determined post-test year adjustments to PBOP expense. Id. at 106. The Department has determined that funding the tax-deductible amount is consistent with Department precedent and strikes the best balance in allocating PBOP expenses appropriately between current and future ratepayers and between ratepayers and shareholders. Massachusetts Elec. Co., D.P.U. 95-40 at 39 (1995), Massachusetts Elec. Co., D.P.U. 92-78 at 83.

FG&E incurs two types of PBOP expense. Exh. FGE-MHC-1 (Electric) at 048; Exh. FGE-MHC-1 (Gas) at 045. One is the accrual for post-employment benefits related to current employees, which expense is the actuarially determined-FAS 106 cost. Exh. FGE-MHC-1 (Electric) at 048; Exh. FGE-MHC-1 (Gas) at 045. Because the FAS 106-portion relates to current employees, part of this actuarial cost is charged to capital accounts, in order to appropriately reflect the profile of work activities engaged in by current employees. Exh. FGE-

MHC-1 (Electric) at 048; Exh. FGE-MHC-1 (Gas) at 045. The other PBOP expense is the "pay as you go" cash expense incurred by FG&E on an annual basis to fund the Unitil Retiree Trust ("URT"), from which URT pays retirement benefits to the retired employees of FG&E. Exh. FGE-MHC-1 (Gas) at 045; Exh. FGE-MHC-1 (Electric) at 048.

The adjustment calculates the cost of both the FAS 106 and URT portions allocated to the Electric Division and to the Gas Division. Exh. FGE-MHC-1 (Electric) at 048; Exh. FGE-MHC-1 (Gas) at 045; DTE RR-6 updated 10/02/02; Exh. FGE-MHC-1 (Gas) at Sch. MHC-7–8 (Gas); Sch. MHC-7-6 (Electric). The allocated Electric and Gas Division FAS 106 expense is reduced by the amount chargeable to capital. Id.

Once the test year PBOP O&M expense is subtracted from the total of the known FAS 106 and URT O&M expenses for 2002 allocated to the Electric Division, the total Electric Division pro forma adjustment is $54,556, and the total Gas Division pro forma adjustment is $11,513. DTE-RR-6 updated 10/02/02 at Sch. MHC–7-6 (Electric) and Sch. MHC-7-8 (Gas).

According to the Attorney General, the Department should reject FG&E's proposed adjustment to the cost of service for the estimated contribution to the URT because it is not known and measurable. AG Br. at 33. In addition, the Attorney General claims it would be appropriate to reject FG&E's proposed FAS 106 expense adjustment since there is no corresponding cash contribution to a PBOP trust fund to cover the cost. AG Br. at 33. The Attorney General's arguments should be rejected.

The Attorney General has not requested substantiation of the 2002 URT funding level, but raises this issue for the first time on brief. FG&E's 2002 cash contribution to the URT is known and measurable. See Exh. FGE-URT Board Vote.

In addition, the 2002 FAS 106 cost is known and measurable. Exh. AG-1-48 (Common). The Attorney General is contradicting his own arguments that FG&E should be containing costs when he argues that this known expense should be rejected by the Department simply because there was no corresponding cash contribution to a PBOP trust fund. AG Br. at 33. Due to the small size of the FAS 106 expense for FG&E, in fact, FG&E has again taken steps to minimize costs by not establishing an associated trust and incurring the fees and expenses associated with such a trust. FG&E is unlike other utilities that incur significantly more expense, have established trusts to administer the funds, and -- importantly -- have requested associated rate increases to offset these expenses when the trusts were initially established. To adopt the Attorney General's recommendation for the Department to deny the proposed Company adjustment for 2002 would in effect penalize FG&E for appropriate cost containment actions. The Department should allow both PBOP expense adjustments as proposed by FG&E and reject the Attorney General's incorrect and misguided arguments.

h. Property and Liability Insurance (Common)

FG&E's Property and Liability Insurance expense adjustment is a pro forma increase to test year Electric Division Property and Liability Insurance expense of $111,051. Exh. FGE-MHC-1 (Electric) at Sch. MHC-7-7 (Electric); Exh. AG-7-35 (Gas, Electric, Common). Also, it is a pro forma adjustment that reduces test year Gas Division Property and Liability expense by $9,172. DTE-RR-6, Updated 10/02/02; Exh. FGE-MHC-1 (Gas) at Sch. MHC–7-9 (Gas). The final adjustment is based on known and measurable property and liability expenses for calendar year 2002. Exh. AG-7-35 (Gas, Electric, Common).

Property and Liability Insurance coverage includes a number of types of insurance that provide protection from casualty and loss, and other damages that FG&E may incur in the conduct of its business. Exh. FGE-MHC-1 (Electric) at 049; Exh. FGE-MHC-1 (Gas) at 046.

FG&E's insurance program includes both premium-based and self-insured coverage, in order to obtain the widest portfolio of prudent insurance coverage at the most reasonable cost. Exh. FGE-MHC-1 (Electric) at 049; Exh. FGE-MHC-1 (Gas) at 046.

An adjustment to test year Property and Liability Insurance expense levels is necessary to reflect known and measurable changes being experienced in 2002. Exh. FGE-MHC-1 (Electric) at 049; Exh. FGE-MHC-1 (Gas) at 046. In addition, the per books Property and Liability Insurance level must be adjusted to reflect the amount to be charged to capital for ratemaking purposes. Exh. FGE-MHC-1 (Electric) at 049-050; DTE-RR-6, updated 10/02/02; Exh. FGE-MHC-1 (Electric) at Sch. MHC-7-7 (Electric); See also, Exh. FGE-MHC-1 (Gas) at 046; DTE-RR-6 updated 10/02/02; Exh. FGE-MHC-1 (Gas) at Sch. MHC – 7-9 (Gas).

FG&E acquires a portion of its insurance portfolio, the premium-based coverage, as an expense common to both the Electric Division and the Gas Division, or in other words, on a total-company basis. Exh. FGE-MHC-1 (Electric) at 050; Exh. FGE-MHC-1 (Gas) at 047. Therefore, the first step of the adjustment calculates the cost appropriately allocated to the Electric Division, or the Gas Division. Exh. FGE-MHC-1 (Electric) at 050, (Gas) at 047.

The self-insured general liability claims, however, are acquired separately and are therefore identified separately by the Electric Division and by the Gas Division. DTE-RR-6, updated 10/02/02 Exh. FGE-MHC-1 (Electric) at Sch. MHC–7-7 (Electric), line 12; Exh. FGE-MHC-1 (Gas) at Sch. MHC–7-9 (Gas), line 12. At this point, the total cost for the Electric and Gas Divisions is further reduced by the amount appropriately chargeable to capital. DTE RR-6, Updated 10/02/02; Exh. FGE-MHC-1 (Electric) at Sch. MHC–7-7 (Electric); Exh. FGE-MHC-1 (Gas) at Sch. MHC–7-9 (Gas).

The Attorney General does not contest the pro forma decrease in insurance expense of the Gas Division. He does, however, argue that the Department should reject the Electric Division pro forma insurance expense because FG&E failed to support its request with record evidence, did not indicate that it sought to negotiate lower premiums with its insurer or that it solicited any bids or RFP's from insurance carriers. AG Br. at 27. The Attorney General attributes these same criticisms to portions of the overall pro forma insurance expense associated with Directors' and Officers' Liability Insurance, excess liability insurance and all risk insurance. Finally, the AG alleges that the benefit of FG&E's continuity credits with AEGIS is offset by broker consulting fees. AG Br. at 34. Given due consideration of the record evidence, these accusations are without merit.

The pro forma 2002 property and liability expense is known and measurable. Exh. AG-7-35 (Gas, Electric, Common). Mr. Collin fully explained the reasons for the general increases in premiums and the details accounting for the "hardening of the market" which has impacted all insurance carriers and the market for insurance in general. Tr. 8/23/2002 (Vol. 11) at 1385-86; Tr. 9/6/2002 (Vol. 13) at 1561-1564. Contrary to the Attorney General's allegations that FG&E did not seek to negotiate lower premiums with its insurer and did not solicit bids from its insurance carriers, FG&E in fact does bid or benchmark all its insurance policies on "at least" a five year cycle, and sometimes as frequently as three-years. Tr. 8/23/02 (Vol. 11) at 1387. The fact that FG&E did not do so this year is immaterial to whether the expense amount is just and reasonable; the evidence demonstrates that issuing a brand-new RFP every year is both costly and adversely impacts the relationship and associated continuity benefits with insurance carriers. Tr. 8/23/2002 (Vol. 11) at 1387.

Mr. Collin explained that FG&E did issue an RFP for excess liability, D&O and workers compensation at various points within the last five years. Tr. 8/23/2002 (Vol. 11) at 1388. Furthermore, between bids, FG&E does not remain idle, but rather, continually monitors the market and seeks cost containment opportunities through the use of an experienced and active broker working in the market who is able "to assess our current policies, our current premiums, and essentially advise us on whether we should be raising issues with our insurance carrier about premium levels and seeking alternative carriers." Tr. 8/23/2002 (Vol. 11) at 1388. The evidence is clear that there has been no malfeasance on the part of FG&E in its acquisition of P&L insurance.

The Attorney General then attacks the methodologies employed by FG&E to contain costs and alleges that the credits that the market provides for business continuity are offset by consulting fees to the broker, for no apparent benefit. AG Br. at 34. However, Mr. Collin has clearly explained the beneficial services provided by the broker and the Attorney General's argument as to the impact of these fees on the benefits of the continuity credits is totally unfounded when one looks at the facts behind his claim. FG&E paid annual consulting fees of $15,000 for D&O coverage and received continuity credits for D&O insurance of $123,426. Exh. AG-7-35 (Gas, Electric, Common); Attachment pages 12 and 13; Tr. 8/23/2002 (Vol. 11) at 1380.

Accordingly, the Attorney General's challenge to FG&E's pro forma Electric Division and Gas Division liability and property insurance expense should be rejected.

i. Bad Debt /Uncollectibles

The Department permits companies to include for ratemaking purposes a representative level of uncollectible revenues as an expense in cost of service. Massachusetts Elec. Co., D.P.U. 95-40 at 54 (1996); Boston Gas Co., D.P.U. 96-50 (Phase I) at 71. The Department has found that the use of the most recent three years of data available is appropriate to formulate a reasonable level of uncollectible expense. Id.; Berkshire Gas Co., D.T.E. 01-56 at 96. The Department looks to ensure that utilities are reasonable and persistent in their collection efforts. Massachusetts Elec. Co., D.P.U. 95-40 at 55.

The method used by FG&E for calculating the uncollectible adjustment ratio comports with Department precedent. Exh. FGE-MHC-1 (Electric) at Sch MHC-7-8 (Electric); Exh. FGE-MHC-1 (Gas) at Sch MHC-7-10 (Gas).

(A) Electric Division

The Electric Division seeks approval of a pro forma decrease of $342,823 of bad debt expense. See Exh. FGE-MHC-1 (Electric) at Sch. MHC – 7-8 (Electric).

Amounts were totaled over the past three years, including the test year, of actual net write-offs and revenues. The years used were 1999, 2000, and 2001. Exh. FGE-MHC-1 (Electric) at Sch. MHC–7-8 (Electric). The Bad Debt ratio was determined by dividing total net write-offs by total electric operating revenue. Id. Test year electric operating revenue was then multiplied by the Bad Debt ratio to derive the Bad Debt expense for ratemaking purposes. Id. This amount was further reduced by the percent of expense attributable to, and that FG&E proposes to recover through, Standard Offer Service ("SOS") and Default Service ("DS") to derive the bad debt expense for the purpose of distribution base rates.[23] After subtracting the Electric Division's test year level of Bad Debts expense, a pro forma decrease of $342,823 to FG&E's test year bad debt expense results. See Exh. FGE-MHC-1 (Electric) at Sch. MHC – 7-8 (Electric).

[23] The percent of expense attributable to SOS and DS is based on the ratio of net write-offs related to SOS and DS to total net write-offs during the test year. Exh. FGE-MHC-1 (Electric) at 051; Exh. FGE-MHC-1 (Electric) at Sch. MHC-7-8 (Electric).

This proposal is new, but it comports with the Department's consistent policy initiative to matching price points with the cost of the service rendered to customers. In contrast, total Bad Debt expense is currently collected as a component of FG&E electric base distribution rates and shared with no other sector of service. Exh. FGE-MHC-1 (Electric) at 051. Since the FG&E customer billing system is capable of tracking account write-offs by specific billing component, FG&E proposes that Bad Debts be allocated to SOS and DS, based on the actual amount of customer account write-offs recorded and tracked for the SOS and DS billing components as a ratio of the total amounts of write-offs for the Electric Division. Exh. FGE-MHC-1 (Electric) at 052. In this way, the SOS and DS component of Bad Debts would vary based on the actual write-offs and would more accurately reflect the actual cost of providing these services. Exh. FGE-MHC-1 (Electric) at 052.

(B) Gas Division

The Gas Division proposes a pro forma decrease in bad debt of $133,586. The amount was calculated as follows. Amounts were totaled for the past three years (1999, 2000, and 2001) including the test year, of actual net write-offs and firm revenues. Exh. FGE-MHC-1 (Gas) at Sch. MHC–7-10 (Gas), lines 1 through 3. The firm revenues for 2001 include the correction for unbilled revenues. Exh. FGE-MHC-1 (Gas) at Sch. MHC-7-1 (Gas). The Bad Debt ratio was determined by dividing total net write-offs by total firm revenues. Exh. FGE-MHC-1 (Gas) at Sch. MHC-7-10 (Gas), line 5. Test year firm revenues, normalized for weather and unbilled revenue adjustments, were then multiplied by the Bad Debt ratio to derive the Bad Debt expense for ratemaking purposes. Exh. FGE-MHC-1 (Gas) at Sch. MHC-7-10 (Gas), line 9. Finally, the test year level of Bad Debt expense was subtracted, resulting in a pro forma decrease of $133,586 in Bad Debt expense. See Exh. FGE-MHC-1 (Gas) at Sch. MHC–7-10 (Gas), line 11.

The Department has found that allocating uncollectible expense between base rates and the CGAC is necessary to reflect customer migration from firm service to transportation service. Boston Gas Co., D.P.U. 93-60 at 412-413. As approved by the Department, a portion of the Bad Debts expense is collected in base distribution rates (43%); a portion is collected in the CGAC (57%). D.T.E. 98-51 at 50-51. The allocation between base distribution rates and the CGAC was initially set in FG&E's last gas rate proceeding based on the ratio of test year normalized non-gas and gas revenues to total revenues. D.T.E. 98-51 at 50; see also Exh. DTE-5-4.

However, in this proceeding FG&E proposes a modification to the method for allocating Bad Debts expense for CGAC recovery. Exh. FGE-MHC-1 (Gas) at 048. Since FG&E's customer billing system is capable of tracking account write-offs by specific billing component, FG&E proposes that the Bad Debts expense be allocated between base distribution and the CGAC, based on a ratio of actual account write-offs recorded and tracked for the CGAC billing components to total write-offs for the Gas Division. Exh. FGE-MHC-1 (Gas) at 048; Tr. 9/10/02 (Vol. 15) at 1795-1797. In this way, the CGAC component of Bad Debts would vary based on the actual write-offs ratio calculated for the CGAC billing components during the costing period and would more accurately reflect the actual cost of providing this service. Exh. FGE MHC-1 (Gas) at 048-049; Tr. 9/10/02 (Vol. 15) at 1796.

ii. Response to Attorney General

(A) Level of Bad Debt

The Attorney General's core argument contesting FG&E's pro forma decrease in the level of bad debt expense is that FG&E has deviated from the substance of the Department's standards for Bad Debt Adjustments with the recording of bad debts at the end of the test year. AG Br. at 21. The Attorney General recommends that the Department require FG&E to exclude the December write-offs from the calculation and direct FG&E to use the average gross write-offs per month for the months January through November of the test year for the bad debt expense adjustment. AG Br. at 23. However, this recommendation does not follow the record evidence: the Attorney General's arguments to exclude a test year known and measurable level of write-offs in the calculation should be dismissed. FG&E has supported the test year-end level of write-offs with ample record evidence as to the reasons for the level of write-offs and steps taken to reduce the level of write-offs during the test year.

With regard to the test year 2001 level of net write-offs, the evidence demonstrates that in the second quarter FG&E began to notice the increase in "over-90 day" accounts as a result of high energy costs and the effective winter moratorium on shut-offs. Tr. 9/6/2002 (Vol.13) at 1572., Exh. DTE-1-20 (Gas). The Department sanctioned FG&E's policies in relaxing its rules enforcing payment during this period. Tr. 9/6/2002 (Vol. 13) at 1557. Furthermore, FG&E continually engaged in measures to reduce bad debt expense, such as the utilization of an increased number of collection agencies, the revision of internal control procedures to insure that customers on payment plans are keeping current on their accounts, the enhancement of internal programs to expedite the review of delinquent accounts and enhanced interaction with fuel assistance agencies and customers. Exh. DTE-1-21 (Gas).

In spite of these efforts following the winter of 2001, Mr. Collin explained:

> [O]ur external auditors basically required us to take a hard look at that over-90 and determine whether or not it was likely that we would ever be able to collect those amounts. And after that analysis, the Company determined that it needed to do an additional write-off for the fiscal year. . . [Grant Thornton] instructed the company to watch that very closely through the year and if we were unable to collect those amounts or come up with a method of collecting those by year end, that it was probable that we would have to make an appropriate accounting adjustment to write them off.

Tr. 9/6/2002 (Vol. 13) at 1558.

Because of this, while FG&E continued to monitor the level of over-90-day accounts and increased its collection efforts, it was required to make additional December write-offs. Tr. 9/6/2002 (Vol. 13) at 1559.

(B) Allocation of Bad Debt to the CGAC

The Attorney General opposes FG&E's proposal to more accurately track the portion of bad debt costs allocable to gas costs or to distribution rates, and argues that the Department should reject the proposal as an unnecessary complication to the CGA that is not in compliance with Department precedent and provides FG&E with guaranteed recovery of a cost that is substantially within FG&E's control. AG Br. at 76-77. The Attorney General provides no support for his allegation that the proposal is contrary to Department precedent rather he claims baselessly that FG&E would have an incentive to manipulate the calculation toward recovering a larger portion of bad debts through the CGAC. This allegation is unfounded and unsupported by any evidence. Further, if gas costs are considered to be recoverable "dollar-for-dollar" through the CGAC due to the volatility of these costs, the associated gas cost bad debt portion of these costs should not be treated differently. As Mr. Collin explained, high energy prices were one of the reasons for the increase in 90-day accounts and the high level of write-offs in the test year, Tr. 9/6/2002 (Vol. 13) at 1572, Exh.. DTE 1-20 (Gas). The Department has consistently based pricing on costs. D.T.E. 98-51 at 140; Massachusetts Elec. Co., D.P.U. 92-78 at 116 (1992). FG&E has the ability to track those costs more accurately. Exh. FGE-MHC-1 (Gas) at 048.

The Attorney General's arguments should be dismissed. FG&E's proposals in this regard support long-standing Department policy.

j. Unitil Service Corp. ("USC") Service Charge (Common)

FG&E's revenue requirement includes a test year level of allocated expenses for USC, or service company, costs charged to the Electric Division and to the Gas Division. Exh. FGE-

MHC-1 (Electric) at 056; Exh. FGE-MHC-1 (Gas) at 051. In FG&E's last Gas Division rate case, the Department directed FG&E to complete a year-end audit for the purposes of FG&E's next rate case filing (gas or electric) so that actual test year amounts of allocated charges are available for the Department's review. D.T.E. 98-51 at 31. Accordingly, an internal test-year-end 2001 audit was performed of the actual test year amounts of allocated charges to the Electric Division and to the Gas Division by USC. Exh. FGE-MHC-5 (Electric); Exh. FGE-MHC-5 (Gas). Further, during the course of this proceeding, FG&E provided detailed information on the services provided by USC and the related, at-cost, USC expenses. Exh. DTE 3-5 (Common), Exh. DTE 3-6 (Common), Exh. DTE 4-22 (Common).

The test year USC charges were examined as part of the internal audit. Exh. FGE-MHC-1 (Electric) at 056; Exh. FGE-MHC-5 (Electric); Exh. FGE-MHC-1 (Gas) at 051; Exh. FGE-MHC-5 (Gas). The service company costs include wages and allocated overhead expenses for the service company operations. Exh. FGE-MHC-1 (Electric) at 056; Exh. FGE-MHC-1 (Gas) at 051. Unitil makes no profit on service company charges to the retail distribution affiliates. Exh. FGE-MHC-1 (Electric) at 056; Exh. FGE-MHC-1 (Gas) at 052. Pursuant to SEC requirements, all USC charges are billed to FG&E at the same cost incurred by the service company in rendering the service. Exh. FGE-MHC-1 (Electric) at 056; Exh. FGE-MHC-1 (Gas) at 051. USC uses a Time & Billing System, to record and determine Labor and Overhead expenses of USC that are attributed to FG&E. Exh. FGE-MHC-1 (Electric) at 057; Exh. FGE-MHC-1 (Gas) at 052. The portion of Labor billed to FG&E is determined based on employee monthly time sheets. Exh. FGE-MHC-1 (Electric) at 057-058; Exh. FGE-MHC-1 (Gas) at 052. USC Overheads are generally allocated to FG&E based on the percent of Labor billed to FG&E. Exh. FGE-MHC-1 (Electric) at 058; Exh. FGE MHC-1 (Gas) at 052-053. Each month, USC renders an invoice for payment to FG&E. Exh. FGE-MHC-1 (Electric) at 058; Exh. FGE-MHC-1 (Gas) at 053.

The manner in which USC charges for its services is reasoned and appropriate. Each monthly invoice lists hours and dollars associated with the services provided by each USC functional area, as well as Direct Charges to FG&E. Exh. FGE-MHC-1 (Electric) at 058; Exh. FGE-MHC-1 (Gas) at 053. Direct Charges represent expenses paid by USC that are being specifically identified and charged directly to an affiliate; therefore, the Direct Charge line item on the service bill enables USC to bill costs incurred solely for the benefit of a particular affiliate directly to the appropriate affiliate. Exh. FGE-MHC-1 (Electric) at 058; Exh. FGE-MHC-1 (Gas) at 053. A supporting schedule then details the charges for each functional category by department, providing a further breakout of charges between Labor and Overhead. Exh. FGE-MHC-1 (Electric) at 058; Exh. FGE-MHC-1 (Gas) at 053. The final page of the invoice summarizes how the service company charges are recorded in FG&E's General Ledger. Id.

During the test-year, FG&E (the Electric and Gas Divisions combined) incurred approximately 40% of the total service company expenses. Exh. FGE-MHC-5 (Electric) at 3 (shows the total service company expenses for the test-year, by expense type); Exh. FGE-MHC-5 (Electric) at 4 (shows the portion of the service company expenses incurred by FG&E by component). The analysis provides a requisite break-out of costs allocated between the Electric Division and the Gas Division. Exh. FGE-MHC-5 (Electric); See also Exh. FGE-MHC-5 (Gas).

The manner in which service company costs are allocated and charged to FG&E has been approved by the Securities and Exchange Commission under the provisions of that agency's regulatory oversight pursuant to the Public Utility Holding Company Act. Tr. 9/9/2002 (Vol. 14) at 1730. However, for Massachusetts ratemaking purposes, FG&E has reviewed the particulars of the service company charges to ensure that the base level of service company costs included in FG&E's operating expenses include only those amounts that comport with Department precedent for inclusion in rates. FG&E determined that donations, certain membership fees, market development costs and advertising expense likely would not comport with Department precedent for rate recovery. Further, FG&E determined the total amount of these charges allocated to FG&E, and then to the Electric Division and Gas Division, and reduced the test year O&M Expense for each division by that amount, or $24,743 for the Electric Division and $12,481 for the Gas Division. Exh. FGE-MHC-1 (Electric) at Sch. MHC–7-11 (Electric); Exh. FGE-MHC-1 (Gas) at Sch. MHC-7-12 (Gas).[24]

The Attorney General correctly notes that FG&E inadvertently included non-jurisdictional advertising costs of $1,994 for its Electric Division O&M Expense in the Revenue Requirement. The Department should note that FG&E previously removed the amount from its updated cost of service. The Attorney General's concern is moot. DTE-RR-6 (Electric) updated 10/02/02 at MHC-7-11 (Electric). FG&E also discovered that the amount of $1,006 related to the Gas Division was not appropriately recoverable in cost of service and previously removed it from the updated cost of service. DTE-RR-6 (Gas), updated 10/02/02 at Sch. MHC-7-12 (Gas).

The Attorney General complains that FG&E's rates should not include interest expense incurred by USC and paid for as part of the service company cost. AG Br. at 19. The Attorney General's argument is bereft of logic and plainly wrong for a number of reasons. First, recovery of interest expense is a legitimate and appropriate rate construct. Department precedent

---

[24] In D.T.E. 98-51, the Department directed FG&E to ensure that any future SEC audit expenses were charged to a separate job number for direct tracking for ratemaking purposes. Fitchburg Gas and Elec. Light Co., D.T.E. 98-51 at 42. However, the SEC has not audited Unitil since 1997. Exh. FGE-MHC-1 (Gas) at 053. In the event of a future SEC audit, FG&E will establish a unique job order number to track and accumulate the expenses associated with the audit. Exh. FGE-MHC-1 (Gas) at 053. This tracking and accumulation will ensure that the SEC audit expenses are properly considered for ratemaking purposes. Id.

recognizes that a company is entitled to be reimbursed for the costs associated with use of its own funds and for the interest expense it incurs for borrowing. Western Massachusetts Elec. Co., D.P.U. 87-260 at 22-23 (1987).[25] While a regulated company recovers these costs in its return on rate base calculation, the fact is that USC has no ratemaking formula that includes "working capital;" indeed, it has no rate base upon which to calculate a return. Nevertheless, USC actually incurs this expense in order to serve FG&E and its customers. Exh. FGE-MHC-1 (Electric) at 057; Exh. FGE-MHC-1 (Gas) at 052. It is not regulated at FERC or by the Department. It exists to serve the management, financial, engineering and professional needs of Unitil companies. It has no means of recovering this legitimate cost other than as the incurred interest expense that it is.

Second, under the SEC requirements, USC charges FG&E for all of its services at cost. FG&E cannot now adopt USC's interest expense as part of its own return on rate base calculation. Yet FG&E must pay USC's total bill for services. Therefore, interest expense is a legitimate cost, prudently incurred in serving customers, that must be permitted for recovery.

Third, unlike the advertising, donations, market development costs, and certain club memberships, which FG&E has deducted because, under the Department's reasoning and precedent these expenses are prohibited jurisdictionally, interest expense is a legitimate expense incurred by USC on behalf of FG&E. To accept the Attorney General's reasoning would deny recovery of costs legitimately incurred by USC, and legitimately billed to FG&E, and trap those

[25] This reimbursement is accomplished by adding a working capital component to the regulated company's working cash computation. Boston Gas Co., D.P.U. 93-60 at 58 (1993). Infrequently, the Department has permitted a regulated company to include in O&M expense the amortization of an extraordinary non-recurring expense for the purpose of computing a company's working capital requirement. Western Mass. Elec. Co., D.P.U. 85-270 at 237; Boston Edison Co., D.P.U. 1700 at 89 (1984).

costs by providing FG&E no means to recover from ratepayers legitimate expenses incurred for their benefit.[26]

Fourth, the Attorney General complains that USC borrowings and investments are "neither reviewed nor approved by the Department." AG Br. at 20. However, the Department has broad authority to investigate and ensure itself of the reasonableness of dealings between a regulated company and its affiliates, a point the Attorney General curiously ignores. M.G.L. c. 164, sec. 76A. A large number of discovery requests asked about the relationship and dealings between USC and FG&E and were apparently sufficient to assure both the Attorney General and the Department of the legitimacy of the dealings between these companies. Exh. DTE 3-5 (Common); Exh. DTE-3-6 (Common); Exh. DTE-3-7 (Common); Exh. DTE-3-8 (Gas, Electric, Common); Exh. DTE-3-9 (Common) Exh. DTE 3-10 (Common); Exh. 4-22 (Common). Therefore, the Attorney General's litany of hypothetical affiliate misdeeds (AG Br. at 20) are completely unsupported by the record and, are inconsistent with the evidentiary record which demonstrates that the services provided by USC overwhelmingly benefit FG&E and its ratepayers. Exh. FGE-MHC-1 (Gas) at 009-010; Exh. FGE-MHC-1 (Electric) at 010. The interest expense incurred by USC, which is part of the USC at-cost charges to FG&E, is a legitimate and appropriate cost to be recovered by FG&E in its revenue requirement, and the Attorney General's recommended disallowance should be dismissed.

k. FG&E Local Advertising (Common)

Department precedent allows for recovery of informational advertising and safety-related advertising as well as promotional advertising targeted to direct competition with unregulated

[26] Furthermore, there is no "double recovery" possible, as the Attorney General feigns in Fn. 16. What Mr. Collin explained is that USC's interest expense in *the nature of* the cash working capital requirements of a regulated company. However, FG&E's rate base recovers *its* cash working capital requirements, but not *USC's* interest expense. What is in the USC expense -- that the Attorney General seeks eliminated -- is the dollar amount attributed to FG&E for the actual interest expense incurred by USC to fund USC's own operations, not FG&E's.

fuels (i.e. oil). G. L. c. 164 § 33A. All other promotional or image-related advertising or associated incentives are not allowed in cost of service for ratemaking purposes. Bay State Gas Co., D.P.U. 92-111-A at 8 (1993); G.L. c. 164, § 33A.

In compliance with this precedent, FG&E has adjusted test year expenses to remove image-related advertising for both the Electric and Gas revenue requirement. DTE RR-6, updated 10/02/02, Sch. ADJ (Electric) (Gas), line 9; Exh. FGE-MHC-1 (Electric) at Sch. MHC-7-9 (Electric); FGE-MHC-1 (Gas) at Sch. MHC-7-13 (Gas); Exh. DTE-5-15. The adjustment reduces test year advertising/promotions expense by $10,786 for the Electric Division. DTE-RR-6, updated 10/02/02, at Sch. ADJ (Electric), line 11; see also Exh. DTE-7-28; Exh. AG-7-24 (Electric) The adjustment reduces test year advertising/promotions expense by $3,781 for the Gas Division. DTE RR-6, updated 10/02/02, Schedule ADJ (Gas), Line 10; See also Exh. DTE-7-28; Exh. AG-5-24 (Gas).

l. Gas/Electric Common Cost Allocation (Common)

The G/E common cost allocation adjustment decreases the level of remaining test year allocated O&M expense to the Gas Division by $53,140 and increases the test year level of allocated taxes other than income taxes by $7,549. Exh. FGE-MHC-1 (Gas) at Sch. MHC–7-14 (Gas), page 2 of 2, lines 32 and 33. The adjustment increases the level of remaining test year allocated O&M expense to the Electric Division by $53,140 and decreases the test year level of allocated taxes other than income taxes by $7,549. Exh. FGE-MHC-1 at Sch. MHC -7-10 (Electric).

The initial basis for allocating test year costs common to the Electric Division and the Gas Division was a study that was conducted in 1978. Exh. FGE-MHC-1 (Electric) at 053; Exh. FGE-MHC-1 (Gas) at 056. As explained by Mr. Collin, because of the changes in the gas and electric industries, including restructuring, the merger with Unitil Corporation in 1992 and the